An "Underdiscussed" Deal Component - Environmental Risk

by Brett McGovern, Esq, CPCU, RPLU

Whether you're on the Buy-side or the Sell-side, don't be called off-sides just because of an environmental exposure in your deal. Environmental insurance products can be utilized to facilitate deals with underlying environmental exposures.

Environmental risk can be considered akin to a product "hidden defect" in a merger and acquisition setting. Though a buyer may enter a transaction with eyes wide open, it may i) either miss a hidden environmental impact, ii) may not be able to conduct due diligence to know whether there is an impact, or iii) actually know of the impact and assume the risk or be indemnified for it by the seller. In any of these cases, there could be a catastrophic occurrence waiting on the other side of the deal closing date that leaves a buyer in an uncomfortable place. Sellers may also take advantage of insurance products to gain coverage certainty. The following scenarios briefly demonstrate how buyers and sellers alike can utilize environmental insurance products to get the deal done.

On the Buy-Side of the deal equation, if a buyer relies purely on the seller's environmental obligations or indemnities, the buyer may be left "holding the bag" if the seller does not comply. Or, the buyer may voluntarily assume the "bag" of legacy (historical) environmental liabilities in the transactional documents. For example, a buyer may assume the environmental risk from the seller for a chemical manufacturing location, and it then becomes fully responsible for all investigation/remediation activities caused by prior owners required under applicable state law. While environmental insurance will not assume the clean-up of known pollution conditions, a custom-tailored solution can be crafted for the unknown pollution conditions and certain toxic tort liabilities. On the Buy-Side, importantly, the operational manufacturing use can be weaved into the coverage component as well for the buyer.

Another example for a Buy-Side environmental insurance request is one in which a buyer exercises an Option Agreement. A buyer may indemnify the seller for certain claims arising from the historical condition of a waste management location that may be part of the broader deal. However, the buyer may refuse to indemnify Seller for claims arising from or related to certain known pre-existing or legacy environmental matters. If that is the case, the deal price will be factored accordingly, as seller will remain responsible for such matters. Environmental insurance products can be adapted in recognition of these split-responsibilities between a Buyer and Seller.

On the Sell-Side, a transaction involving healthcare facilities or commercial real estate may have legacy environmental liabilities for a seller long after it sells its business. In making representations and warranties about a deal generally, sellers may state that i) they have received no written notice from any governmental authority of any violation of any law applicable to the property, and/or ii) all of the due diligence materials made available by seller to buyer with the property are true and complete. The representations and warranties contained in the transaction document may survive for a period of time. Any claim which buyer may have at any time against a seller for a breach of any such representation or warranty, whether such breach is known or unknown, must be made within the allotted period of time, or else the claim will not be considered valid and the seller will be off the hook. However, sellers may indemnify buyers – generally and specifically for environmental impacts – for matters that they, the sellers, caused or even impacts that pre-date the Seller's use or occupancy. A seller may materially induce a buyer to buy its business and associated real estate with an indemnity or other contractual/statutory protection. After its divestiture, the seller may be concerned that it could be brought into environmental litigation either by the buyer or a third party. In either case, the seller may be required to investigate, remediate and achieve environmental closure with the applicable environmental agency, or

even pay for tort-based claims. The seller may also provide a performance obligation to perform remediation work. Whether an indemnity from the seller is provided or a performance obligation is provided by the seller or neither is provided, an environmental insurance product can be considered to protect against certain third party tort claims and unknown historical pollution conditions for the benefit of the Seller, but not for any known remediation itself.

Of course, there are also times when environmental insurance can assist both the Buy-Side and the Sell-Side parties to a given transaction. For example, in one recent corporate transaction, a family LLC was selling its corporate interests to a buyer LLC entity. As part of this deal, a manufacturing facility that had been part of the seller's assets for years was being divested. The creative buyer was looking to develop the site into mixed use with commercial and residential use. Since the family wanted to rid itself of decades-old environmental impacts, they struck a deal with the buyer to enroll the site into a state voluntary cleanup program which will allow the buyer to reach a closure status with the applicable environmental agency. This is especially prudent when buyers seek to change the use of a prior industrial site into residential. Often times, former industrial sites that may be part of a company's portfolio are viewed as valuable because of their proximity to a city or surface water body – which are also attractive elements for habitational uses as well. Incidentally, often times in these transactional settings, public-private-partnerships can also be formed whereby funding for the project comes from a variety of sources such as the state, city and private lenders alike – to get these facilities back on the tax rolls. Investors view this risk-reward scenario as a way for an investment to generate a valuable return.

In conclusion, while certain deals in the M&A world may not include real estate as part of the deal, there will be times when underlying real estate can be a sticking point to a deal; there may be a real or a perceived risk based on the current or historical uses. Buyers will need to beware of real estate assets that have or will have issues that could fall on the buyer long after the deal is done; and, sellers will need to be prudent in deciding which environmental liabilities to maintain and know which liabilities it will keep in common law or by statute no matter what a contractual document says. Whatever the deal structure, both Buyers and Sellers can avoid unknown pitfalls after the deal-closing by inquiring into what environmental insurance products may be available…beforehand. After all, letting environmental risk be "under-discussed" in a deal setting could cause your deal to go under water.

About the Author

Brett McGovern currently serves as an Assistant Vice President at XL Catlin, an insurance carrier. His career includes more than 15 years of experience in environmental insurance at XL Catlin, supporting transactions for much of this time. To learn more about how XL Catlin manages environmental risk in Mergers and Acquisitions, contact Brett at Brett.McGovern@xlcatlin.com, or 610-968-9486.