MITIGATING TRANSACTIONAL ENVIRONMENTAL RISKS

Any business transaction whether buying or selling real estate assets or engaging in a merger and acquisition – obligates the participants to identify "risks" associated with the deal. Generally referred to in present-day commercial business lingo as the "due diligence process" this risk assessment approach has valuable benefits and utilities. Environmental due diligence takes the form of conducting various assessments, evaluations, and investigations intended to daylight pollution liabilities from historical (or current ongoing) operations. Once known, how are these risks appropriately managed / controlled going-forward? Arguably, the simple answer to that question is by employing due-care. How exactly that is achieved, does matter.

Contractual indemnities and insurance (separate or in combination) are the most commonly utilized methods for managing pollution risks in transactions. The traditional Risk Management paradigm requires that these identified liabilities be viewed through the lens of three processes of their management: Institutional, Engineering, and Administrative Controls. The United States Environmental Protection Agency (US EPA) Institutional Controls as "non-engineered and/or legal controls that minimize the potential human exposure to contamination by limiting land or resource use". Whereas, Engineering Controls "consist of engineering measures (e.g, caps, treatment systems, etc.) designed to minimize the potential for human exposure to contamination by either limiting direct contact with contaminated areas or controlling migration of contaminants through environmental media". Administrative Controls "are written procedural mechanisms used for hazard control".[1]

Depending upon perspective, environmental risk mitigation utilizing insurance and liability relief using contractual indemnities crosses over certain aspects of both Institutional and Administrative Controls. It is important at this point to also view this approach to environmental risk management as something that goes beyond merely seeking compliance with a given regulatory statute or mandate. Rather, this discussion of administrative controls will include managing environmental exposures to control potential for downside financial considerations that ultimately could become catastrophic to a business or the transaction's profitability / success for shareholders.

As one might imagine, there are considerable uncertainties associated with contamination risks, which could, among other things, lead to imminent threats to human health and to ecosystems, or worse, could generate a considerable potential for ruinous outcomes. Additionally, social inflation (societies' trend toward increased litigation, broader contract interpretations, plaintiff friendly legal decisions, and larger jury awards) and inevitable allegations of association and the burden of proof being high to defend against spurious lawsuits. This is clear in the way federal and state environmental laws, regulations and precedents have been set to be penal, make an example of, and be joint-and-several.

Footnote 1: [Reference: United States Environmental Protection Agency, Institutional and Engineering Controls Data, https://rcrapublic.epa.gov/, March 2018]

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First, in order to mitigate the risks associated with pollution damages in a transactional context, and by far the most broadly employed, is contractual liability transfer, or more specifically, putting in-place an affirmative environmental indemnity obligation. That can take the form of a commitment by a counterparty (buyer, seller, corporate entity guarantor, principals' assets, escrows or hard currency set-asides). These might be untested commitments, until the time the obligation is called, so there is credit risk associated with this method of environmental risk control in a transactional situation. Also, the question of the scope or limitations of time whereby the indemnity could sunset (or cease) thereby leaving the entity seeking recovery to lay bare, and exposed to terrific losses in the millions of dollars. However high the potential for failure, given the infrequency of such losses occurring, is a major motivating reason why this is employed so frequently and often the go-to method of facilitating deals. Attorney fees to draw up and negotiate such terms are also relatively low and ultimately "baked" into the transactional expenses.

Secondly insurance can certainly play a role to transfer the environmental liability transactional risk. Commercial risk transfer policies from A-rated financial service companies are available and can take the form of Representations + Warrantees Insurance (RWI) or Pollution Legal Liability (PLL) policies. Both policies are underwritten to be specifically tailored to the particulars of the deal terms and are not off-the-shelf, or one-size-fits-all wrapping around the Purchase / Sales Agreement. The protection provided by RWI relative to pollution liability is fairly narrow and must result from a breach in rep / contract terms related to disclosures made associated ultimately with the environmental due diligence conducted and the knowledge of the responsible parties. On the other hand, PLL insurance, on the other hand, could, in certain situations be the desired method for ring-fencing known pollution conditions yet provide defense against the potential for third-party claims for indemnity and legal cost commitments. In the event both PLL and RWI insurances are placed in concert for a given deal, there is the likelihood that underwriters would give broader coverage on each, recognizing an affirmative carrier obligation to defend and pay indemnities related to for environmental claims. There is an accelerating trend towards placing both policies for private equity deals in many industry classes to ensure contract certainty.

An all-encompassing PLL policy for pre-existing (legacy / historical) and new (operational) pollution conditions can be written on a claims-made basis on policy terms up to 10 years in duration. Coverage key features would include:

- 1st and 3rd Party Claims for Clean-Up / Remediation,
- 3rd Party Claims for Property Damage [including Diminution in Value (DIV) and Natural Resource Damages],
- 3rd Party Claims for Bodily Injury and
- Related Legal defense expenses.

Additional coverage offerings / enhancements include, but are not limited to: scheduling disclosed documents to affirm coverage for known conditions, insured contract schedule, excess of indemnity, 1st party DIV, transportation, non-owned disposal site liability, loss of rents / business interruption, some limit of defense costs outside the limit of liability, illicit abandonment / midnight dumping, indoor air quality (mold/legionella), act and non-certified acts of terrorism.

- Some of the hot topics in the PLL marketplace (driving increasing demand) are:
- Using PLL in lieu of tangible asset guarantees for Hazardous Materials Guarantees in loan agreements

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- Emerging contaminants: highly toxic, ubiquitous, and persistent compounds, such as: Per- and Polyfluoroalkyl Substances (PFAS) [e.g. perfluorooctanoic acid (PFOA) and GenX, etc...]
- Coverage for historical obligations related to disposal activities by the predecessors (even if legal / permitted at the time of use)
- Defense costs outside of the policy limit of liability are recently available
- Coverage for "ghost sites" or, those locations for which a predecessor firm operated, but no knowledge currently exists, but from which an environmental contamination contribution claim or regulatory obligation to clean-up could originate

Finally, as noted, there are several means for the mitigation of environmental exposures in the transactional risk context. Contractual indemnities and PLL insurance are the most popular in today's M&A arena. A hybrid approach would have the PLL sit excess of the contractual indemnity obligation and the insurance would be triggered in the event of insolvency, an out-of-scope claim, or exhaustion. This could be employed as a "wrap around" to manage environmental and financial exposures to the new concern. The success of any of these strategies (positive outcomes when faced with an environmental contamination event) is only possible with good information, competent legal representation and technical engineering advice.

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