Managing environmental risks in mergers and acquisitions

Introduction

Environmental risks are liabilities that can be passed on with property and assets in M&A transactions. If they are not allocated properly, they could hold up or endanger a deal.

In our recent webinar on 28 June 2023, we looked at how environmental risks have become critical in transactions. We saw how environmental insurance can help transfer the risk, remove sticking points, and bring benefits for both sellers and buyers.

We also explored:

- How environmental insurance can help meet ESG requirements
- What questions to ask when carrying out environmental due diligence
- Real-world case studies where insurance helped get deals over the line

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What are the main types of pollution?

Industrial pollution isn't just the large oil spills we see on TV — incidents, from disturbing buried waste to leaks that contaminate groundwater, happen every day and can be caused by a wide range of activities.

Historic pollution: after 250 years of industrialization, many buildings sit on top of legacy sites, such as gas works, chemical factories and tanneries. In the past, these operations may have dumped chemicals and buried toxic waste. Pollution that has lain dormant for years can be disturbed and find its way into groundwater or rivers. This is a particular concern in M&A and land deals as the liabilities can be passed on through the transaction.

Soil pollution: generally occurs gradually as a result of buried waste, leaking pipes or poor storage of raw materials.

Surface water pollution: can come from industrial wastewater runoff, a direct spill, or leaking pipelines and storage tanks entering watercourses or drains.

Air pollution: can be gradual, such as greenhouse gas emissions, or a sudden release of pollutants, such as an industrial explosion releasing a toxic cloud of gases.

Odor: is becoming more of an issue through statutory nuisance claims. Odor does not have to impact health, it can just affect quality of life. There is potential for class actions and large legal costs where the odor source is close to residential developments.

Dust: contaminated soil can turn to dust, which is blown around and ingested in dry conditions. If toxic, it can also lead to serious health conditions. It's mostly an issue for construction sites, but can come from some manufacturing activities.

Biodiversity: if pollution disturbs rare plant or animal life in a protected area, companies could be open to prosecution and claims. Damage can also be caused without pollution. For example, if a truck drives over a rare plant, or groundwater extraction causes biodiversity loss.

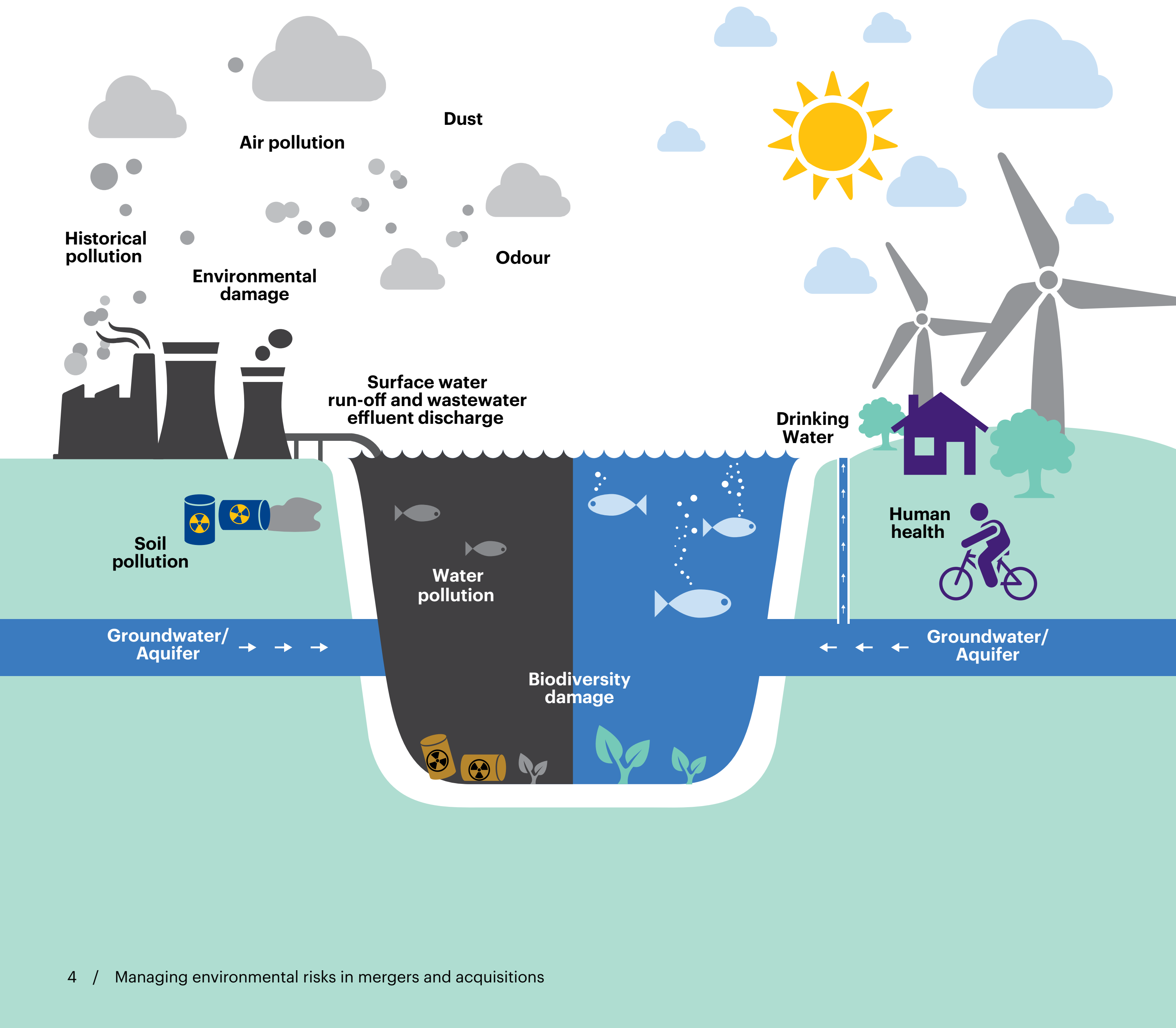
What is an environmental risk?

You need three elements to have an environmental risk:

- A **source** of contamination — for example, an oil drum that's leaked.
- A **pathway** for the contamination to move through — for example through soils and into groundwater.
- A **receptor** for the contamination to cause harm — for example fish in a river or people breathing contaminated dust.

Environmental damage can be prevented by removing at least one of these elements. The obvious way is to clean up the source of contamination, but it's also possible to remove the pathway through some form of physical engineering.

Figure 1: **Source – Pathway – Receptor**



How does environmental risk affect M&A deals?

Environmental liabilities can affect the warranties and indemnities in M&A contracts and potentially get in the way of deal completion.

For example, if a site involved in an acquisition has a known pollution source and there is a potential pathway for it to migrate to a receptor, such as a river, that's a significant risk.

There can also be unknown pollution risks, not identified in the sale and purchase agreement (SPA), which may only emerge post-transaction. All of these potential liabilities should be addressed in the deal to avoid complications down the line.

- **Sellers** will want to pass on the environmental liabilities for the pollution they or previous owners have caused to the new owner, so they can have a clean exit.
- **Buyers** need to be fully aware of what these pollution liabilities are so they can decide whether to take them on. In most jurisdictions, the polluter pays principle applies, meaning the buyer can be financially responsible for all associated costs.

How does environmental insurance help?

Environmental impairment insurance (EIL) can cover both known and unknown future pollution liabilities. Transferring these environmental risks can remove complications and prevent them getting in the way of a deal.

By capping off potentially complex liabilities:

- **Buyers** can improve their bidding position in a competitive bid situation.
- **Sellers** make a clean exit and increase the pool of buyers who might otherwise be put off by those liabilities

EIL policies can also provide much higher limits and longer coverage terms than a typical escrow, improving the long term position of both buyer and seller. Insurers are increasingly willing to provide cover for pollution conditions that are already known.

Figure 2: **Benefits of EIL for M&A**

Benefits for the buyer:
• **Improves competitive-bid position** by reducing/ eliminating escrow or indemnity demands
• Caps or transfers difficult-to-quantify environmental liabilities
• **Provides certainty** in modeling of future cash flows, exit strategy
• Alleviates credit risk of seller's indemnification
• **Protects against undiscovered and/or future environmental liabilities**
• Obtains higher limits and longer coverage term than typical escrow or indemnification agreements

Benefits for the seller:
• Increases net proceeds at closing by reducing/ eliminating escrow requirements
• Obtains higher limits and longer coverage term than typical escrow or indemnification agreements
• Eliminates accounting for indemnification given to the buyer
• Improves risk profile of polluted assets; **increase liquidity via broader pool of prospective buyers**

Filling the gaps in other policies

General liability and property policies only cover third party liability claims for damage caused by sudden and accidental pollution. They don't cover first-party clean-up costs, preventative mitigation costs, biodiversity damage, or potential new risk exposures created by changes in the law.

Most warranty and indemnity (W&I) policies have a blanket exclusion for any claims related to pollution.

These gaps can leave large exposures that are not covered by any existing insurance policy, as shown in *Figure 3* below.

Figure 3: **Gaps in Cover***

	General liability	Property	Environmental
Sudden and accidental pollution	✓	✗	✓ (Optional)
Gradual pollution	✗	✗	✓
Statutory clean-up	✗	✗	✓
On-site first party clean-up	✗	✗	✓
EU environmental liability directive	✗	✗	✓
Biodiversity damage	✗	✗	✓
Loss mitigation	✗	✗	✓

*Please note: Policies do differ and this is representative of a standard general liability and property policy

What does environmental insurance cover?

Environmental impairment insurance (EIL) is designed to fill the gaps outlined on the previous page. It can cover all environmental liabilities whether or not they are passed on by contract, including known and unknown historic pollution risks and new pollution that arises after the transaction completes. Cover can also be extended to environmental risks from activities such as transportation.

First and third party costs

- Liability to third parties for environmental damage and bodily injury.
- Damage and from both sudden and accidental and gradual pollution.
- First party clean-up costs, not just on the client's site but in the surrounding area as well.
- Statutory clean-up costs if an environmental agency carries out work on a client's behalf and sends them the bill.
- Legal defence costs if a client is prosecuted.
- D&O liability for environmental breaches.

Prevention and recovery

- **Pre-incident loss mitigation:** to prevent an immediate risk of environmental damage caused by pollution.
- **Crisis management response:** clients can access a team of PR consultants to manage the message to media and stakeholders as soon as an incident occurs.
- **Site investigation:** investigations to assess the nature and extent of the pollution, how far it goes and how to remediate it.
- **Biodiversity restoration:** the cost of restoring biodiversity lost through pollution, or environmental restoration works somewhere else to make up for the damage caused.
- **Long-term ground water monitoring:** for up to 10-15 years after the incident.
- **Business interruption:** loss of profits if a client's business has to close as a result of an incident.

How does the policy work?

- Buyers can also purchase cover for ongoing operations post-transaction.
- Policies are available covering periods up to 10 years. This means any historic pollution discovered during the previous 10 years can be claimed for, which can give buyers more confidence that all liabilities will be covered.
- Cover can be written to cover individual sites or the entire business, including operations at sites owned by third parties.
- Unlike W&I insurance, the cover does not form part of the SPA. It offers complementary protection, but contractual agreements from the SPA are included.

Common misconceptions and barriers to buying EIL

It's too expensive

The cost of EIL premiums for M&A is dropping, as there is more competition for this type of business. EIL can be much less expensive, and offer much higher limits, than the indemnity available from escrows.

Too much information is needed

It's true that detailed information is required for historic pollution, but most of it will already have been gathered for general insurance, planning processes or as part of environmental compliance.

It's not that big a risk

Businesses can have unknown environmental risks, for example working on a site with historic pollution, which could get in the way of a deal. Gaps in existing insurance policies mean they won't be covered, leaving significant exposures.

Lack of understanding of the regulations

Generally it's safe to assume that regulations will get tougher and businesses will need to do more to demonstrate compliance.

How does EIL help companies meet ESG challenges?

Pollution of soil, water and air has a negative impact, not only on human health, but also on biodiversity and climate change.

Environmental insurance, combined with good environmental management processes, can help businesses to reduce their impacts and improve their ESG rating. It can also help companies meet their ESG reporting requirements and reduce the risk of fines and reputational damage.

More and more general liability and property policies are actively excluding cover for emerging risks. Unlike these policies, EIL can include climate-related environmental damage caused by long-term gradual emissions, which has been an increasing source of claims and legal cases in recent years.

EIL can also cover biodiversity loss whether the loss is caused by pollution or the impact of a company's activities. This is an increasing source of public concern, with regulations developing quickly in many countries.

Environmental due diligence

It's vital to do comprehensive environmental due diligence that not only looks at the environmental risks from current business activities but also the historic risk.

Answering these questions will provide the detail that insurers need to get comfortable with the risk, including known pollution conditions.

Questions to ask

1. **Is the site well managed?**
   There should be a comprehensive environmental management plan to govern all aspects of environmental and pollution risk.
2. **Have all locations been assessed?**
   Some only look at heavy manufacturing locations and not other buildings, such as warehouses and offices. All buildings could be on sites with an industrial past, even if current land use seems low risk and benign.
3. **Have all known conditions been identified?**
   Known conditions are easier to insure if they are clearly identified and discussed in the due diligence report.
4. **Are known conditions being monitored?**
   This is essential to make sure they don't get worse during and after the transaction.
5. **Is remediation planned or completed?**
   Details of any remediation that's happened or planned also makes sites with known pollution issues easier to insure, especially if the remediation has been completed and signed off by the regulator.
6. **Is the regulatory position understood?**
   The due diligence report should include details of contacts and correspondence with the regulator.
7. **Is there insurance in place**?
   It's important to understand about any existing cover, so environmental insurance can be tailored around it.
8. **Is a change in use planned?**
   If the site is being sold for redevelopment, the clean-up requirements and risk profile of the site may change along with the shape of an EIL policy.
9. **Have the biodiversity impacts been considered?**
   This is going to be more important in the future as concern about biodiversity loss increases.

PFAS exclusions

Polyfluoroalkyl Substances (PFAS) are synthetic chemicals used in non-stick, water repellent and heat/stain resistant products. They never break down and remain in the environment forever, making them very difficult to remediate. They can accumulate in the body if ingested.

We're increasingly seeing large claims for PFAS-related damage, especially in the U.S., along with calls for analysis of groundwater near sites where the chemicals have been used.

Most insurers now exclude damage caused by PFAS in new policies. However, clients with long-term policies covering up to 10 years may still be covered, as exclusions can't be applied retrospectively within the policy period.

Case studies

Environmental insurance enables a UK transaction

WTW supported a UK-based private equity fund that was purchasing a large pharmaceutical business on a site with historic industrial use.

Issue: a potential historic pollution issue was identified during due diligence. Neither the buyer nor seller were willing to take on the environmental liability exposure. Commercial pressures would not allow for a delay in the deal timetable to allow for further testing. Insurers were not willing to offer insurance to take the risk off the table.

Solution: to keep the deal moving forward, we worked with the parties to make it a condition of the transaction that insurance was available. We then structured a policy with an insurer that guaranteed to offer cover provided test results were received before deal completion. The language in the insurance policy mirrored the language in the SPA. The arrangement gave time for tests to be done, which were within tolerance levels.

Outcome: this removed the sticking point from the deal, allowing signing to go ahead, with necessary testing taking place between signing and completion.

Solution provides comfort on operational pollution

WTW worked with a global private equity client on a transaction involving a polymer compounding facility in the U.S.

Issue: a risk of contamination from ongoing operations was identified onsite. In our insurance due diligence exercise, we found that the polymer company's general liability policy had a blanket exclusion for any pollution related to polymers and coatings. This meant they had no cover for either a sudden and accidental event nor gradual pollution for their operations.

Solution: we structured a new environmental combined liability programme, providing:

- Pollution cover for the company's products
- Gradual pollution cover onsite
- Cover for a pollution condition while products were in transit

Outcome: this provided our client with sufficient comfort that the target company's environmental exposure was mitigated, giving them the confidence to proceed with the investment.

Summary of key points

- M&A deals can be affected by a broad range of environmental exposures.
- There are large gaps in existing coverage and often no coverage on W&I policies.
- Environmental insurance covers known and unknown pollution and biodiversity exposures.
- Policies are available to cover legacy risks as well as ongoing operational risks.
- ESG exposures are an increasingly important due diligence consideration — it's important to address them early on in the deal process.
- Risk transfer reduces the role complex environmental risks have as part of a deal and strengthens your position at bid stage.
- Policies can cover all of the property and assets in a deal, providing location-specific cover.
- Insurance period can be up to 10 years.
- With our global specialist teams, WTW can provide solutions for all sectors.

Removing complex exposures to move a deal forward

WTW was supporting a global private equity client that was acquiring an industrial manufacturing facility in Eastern Europe.

Issue: a plume of chlorinated hydrocarbons from the factory was known to have migrated off site and affect drinking water abstraction. The groundwater had been monitored for the past 15 years. Concentration levels were reducing, but were still above threshold levels.

Regulators were aware of the situation, but never replied to the monitoring samples sent to them and had not provided any guidance or direction for more than 10 years.

Solution: we helped the client negotiate a two-year policy covering both historic pollution and ongoing operational pollution exposures. Known pollutions conditions were covered, including off-site liabilities for the chlorinated hydrocarbon plume. PFAS chemicals were also included.

Outcome: coverage for the known conditions was a critical factor in progressing with the deal, which went ahead to completion once the insurance was in place.

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