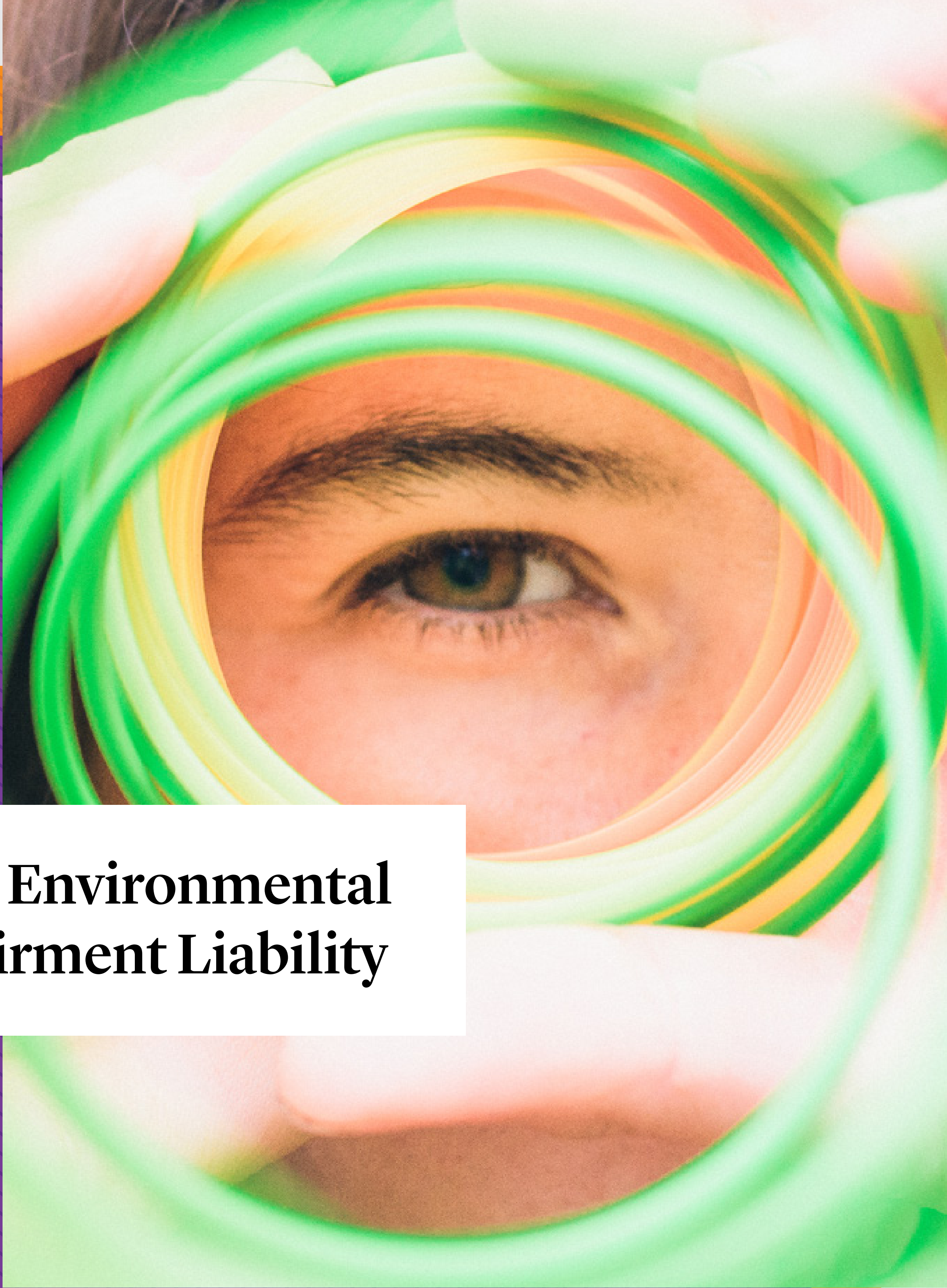

M&A Environmental Impairment Liability

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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 scupper a deal.

In this document, we look at how environmental risks have become critical in transactions. We see how environmental insurance can help transfer the risk, support M&A deals, and bring benefits for both sellers and buyers.

What are the main types of environmental pollution?

Soil – generally occurs gradually as a result of buried waste, leaking pipelines or tanks. Over time soil pollution can also leach into groundwater aquifers and rivers. This can be very difficult and expensive to clean up.

Water – industries from manufacturing to mining and construction create wastewater that needs to be treated before being discharged into a sewer or stored offsite. If that process breaks down and runoff enters the groundwater or nearby rivers, it can cause significant environmental damage. Water pollution can also come from a direct spill, leaking pipelines and storage tanks, or from long-term soil pollution as described above.

Air – gases created by industrial processes need to be filtered before reaching the atmosphere. If the air filtration systems break down, or an accident occurs, this can release toxic plumes, which can cause long-term health conditions and birth defects.

Dust – pollution can also come from contaminated soil turning to dust, which is blown around and ingested in dry conditions. If toxic, this can also lead to serious health conditions.

Odor – bad smells caused by industrial activities, from manufacturing to waste management are becoming more of an issue, leading to class action claims for nuisance. It doesn't have to impact human health, but can just affect quality of life.

Historic – after 250 years of industrialization, there are many contaminated legacy sites, especially in cities. Pollution that has lain dormant for many years can be disturbed and find its way into groundwater or rivers. This is a particular concern for businesses buying or selling property, or developing new sites.

Biodiversity

You don't need to pollute to cause environmental damage. If a company's activities disturb rare plant or animal life in a protected area, they could be open to prosecution and claims.

How does environmental risk affect M&A deals?

The environment is rising up the agenda in boardrooms across the globe. With greater scrutiny of environmental performance, failure to deal with a pollution incident properly can harm a company's reputation and its balance sheet. Meanwhile, governments and regulators are becoming more proactive in enforcing and tightening environmental laws.

These factors mean that environmental liabilities have increased dramatically in recent years. This, in turn, affects the warranties and indemnities that sellers need to provide to buyers in an mergers and acquisitions (M&A) contract.

As well as clean-up costs and long term environmental monitoring post-incident, there can be wider liabilities not normally foreseen in warranties and indemnities, such as:

- Legal costs if a case is brought against the seller or buyer for environmental damage
- Fines and penalties, which can be a percentage of annual turnover
- The costs of reputational damage

Historic land use

Due diligence reports should highlight the known pollution risks associated with a site's recent past. They may also highlight the possibility of pollution from uses in the distant past, but often won't investigate or identify these historic issues, leaving a potential gap in understanding of the potential risks and liabilities.

Understanding historic pollution risks in M&A

If a due diligence report highlights historic pollution, it's important to find out:

- Has every location within the deal been reviewed – for example, not just manufacturing sites, but also office buildings?
- Are there site investigation reports that could identify the known pollution and make it easier to insure?
- Has there been any remediation work in past that means the risk is better understood and more under control?
- How long have the sites been in their current use? If they were built recently, it's likely remediation would have been undertaken as part of the redevelopment.
- Are the previous polluters still around? The polluter pays principle stands in most territories, unless the liabilities have been moved on by contract.

Current land use

With environmental laws and regulation tightening, the chances of a business breaching environmental rules is growing, whether by exceeding their environmental permits or failing to manage waste properly. Due diligence reports should highlight if there are any current problems with environmental management or compliance with permits. However, this may not provide a comprehensive view of all potential risks.

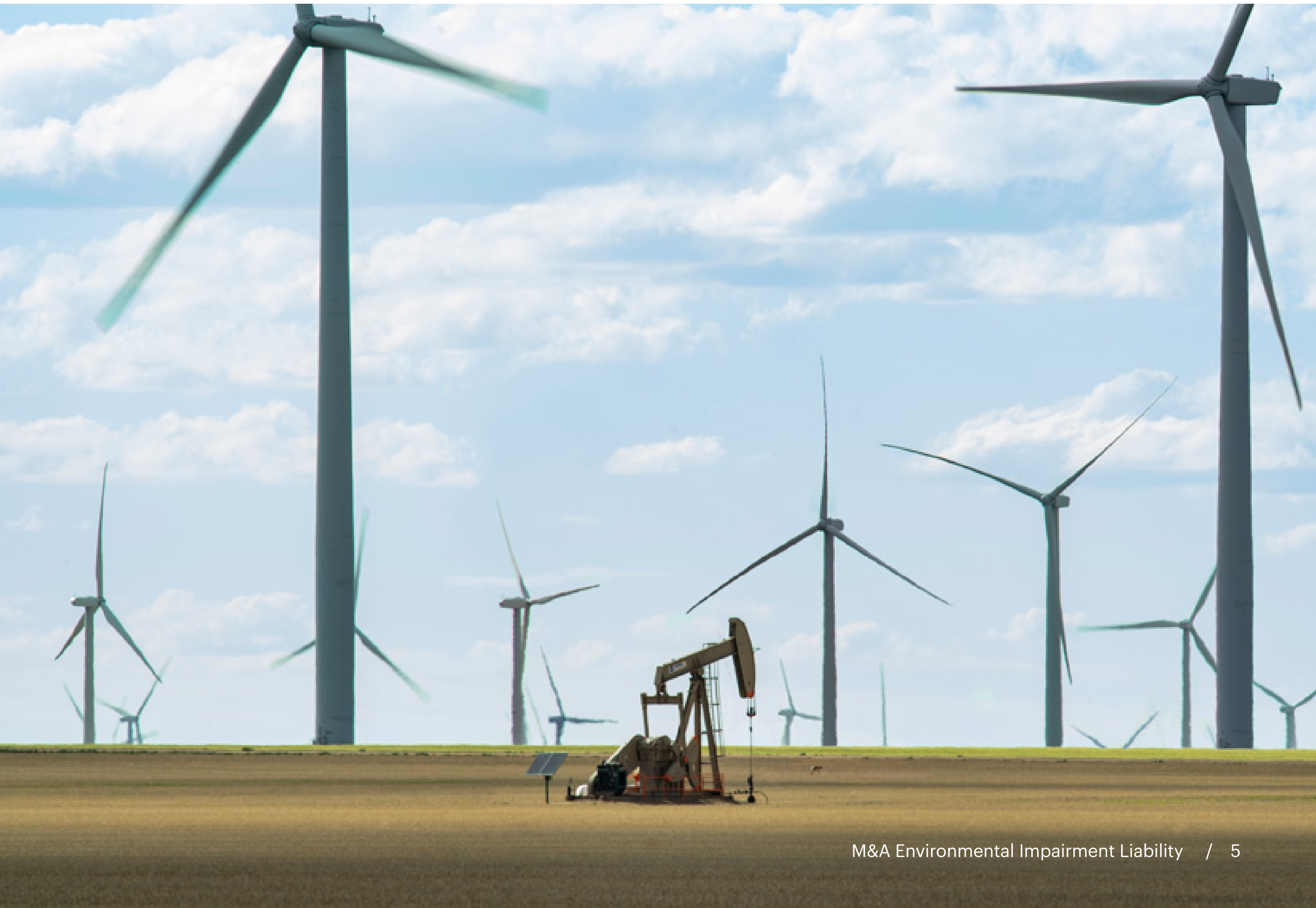
Understanding current pollution risks in M&A

Ask these questions to build a clearer picture of ongoing operational risks:

- How well does the business manage its environmental permits?
- How do they manage their waste including surface water emissions, air emissions and solid and liquid bulk waste?
- How do they store bulk fuel and chemicals?
- Are they investing in technology to improve and taking continuous improvement actions?
- Do they carry out environmental impact assessments?

Figure 1: **M&A risks**

M&A risks for the seller	M&A risks for the buyer
No deal: the transaction could fail if costs of past pollution are not sensibly allocated.	**No deal:** the transaction could fail if costs of past pollution are not sensibly allocated.
Costly guarantees: collateral or escrow arrangements may be required to demonstrate that the seller can pay for known historic liabilities.	**Over-priced transaction:** the property and assets bought may lose value due to unexpected costs of undetected inherited liabilities.
No clean exit: the seller may have to retain environmental risks as a result of Sale and Purchase Agreement (SPA) negotiations or a carve-out of problematic parts of the business.	**Impaired exit strategy:** the buyer may fail to achieve their expected return on investment if selling the business on.



How environmental insurance helps in M&A deals

Known historic liabilities can be difficult to allocate effectively in M&A. The seller may be required to put collateral or escrows in place to reassure the buyer that they can pay those liabilities. This can be expensive and complicate a deal.

As we've seen there may also be unknown historic liabilities, not identified in due diligence reports, as well as current and future pollution risks, which may not be fully visible in the SPA.

Environmental impairment liability (EIL) insurance is an effective way to transfer these risks and liabilities to stop them getting in the way of an M&A transaction.

It can cover both known and unknown historic pollution risks, and also new pollution that arises after the transaction completes, in a single policy. Cover can also be extended to environmental risks from activities such as transportation.

Environmental Impairment Liability (EIL)

The two most widely used EIL policies are Contractors' Pollution Liability (CPL) and Premises Pollution Liability (PPL). PPL is the policy that's relevant to M&A. It provides cover for a client's owned locations. It can be written to automatically cover the entire business, including operations at sites owned by third parties.

PPL is always on a claims made basis. Policies are available covering periods up to 10 years. Excess of loss cover is also available for large programmes and projects.

What does it cover?

First and third party costs

- Liability to third parties for property damage and bodily injury.
- Coverage for 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 public relation (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 damaged as a result of the business' operations; and/or complimentary biodiversity restoration on non-owned land to compensate for the damage you were unable to restore on your own land.
- **Long-term ground water monitoring:** environmental monitoring after an incident can often take in excess of 10 years.
- **Business interruption:** loss of profits if a client's business has to close as a result of an incident.

Figure 2: **Gaps in Cover***

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

*Please note: This table is to be used as a high level guide only for illustrative purposes, policies do differ and this is representative of a standard general liability and property policy

Isn't this covered by other policies?

General liability and property policies typically cover damage caused by sudden and accidental pollution, not the gradual pollution that is involved in most legacy sites. As shown in *Figure 2* above, they don't usually cover first party clean-up costs, preventative mitigation costs, biodiversity damage, or potential new risk exposures created by changes in the law.

Key benefits of environmental insurance for M&A

EIL policies can provide much higher limits and longer coverage terms than a typical escrow, improving the long term position of both buyer and seller.

Because pollution liabilities are often difficult to quantify, it makes sense to have a high policy limit rather than a specified low escrow value which may be based on estimated worse case costs provided by the due diligence consultants. These cost calculations often don't include legal defence costs and other side costs associated with environmental pollution.

Figure 3: **Benefits of EIL**

Benefits for the seller	Benefits for the buyer
Protects against unknown historic and future environmental liabilities.	
Offers higher limits and longer cover than escrow or indemnification agreements.	
Increases profits from the sale by removing the need for escrow.	Improves bid position by removing the need for escrow.
Eliminates accounting for indemnification given to the buyer.	Provides certainty in modelling future cash flows, helping the buyer to sell on.
Improves risk profile of the property and assets, which could attract a wider pool of prospective buyers.	Removes any credit risk associated with the seller's indemnification.

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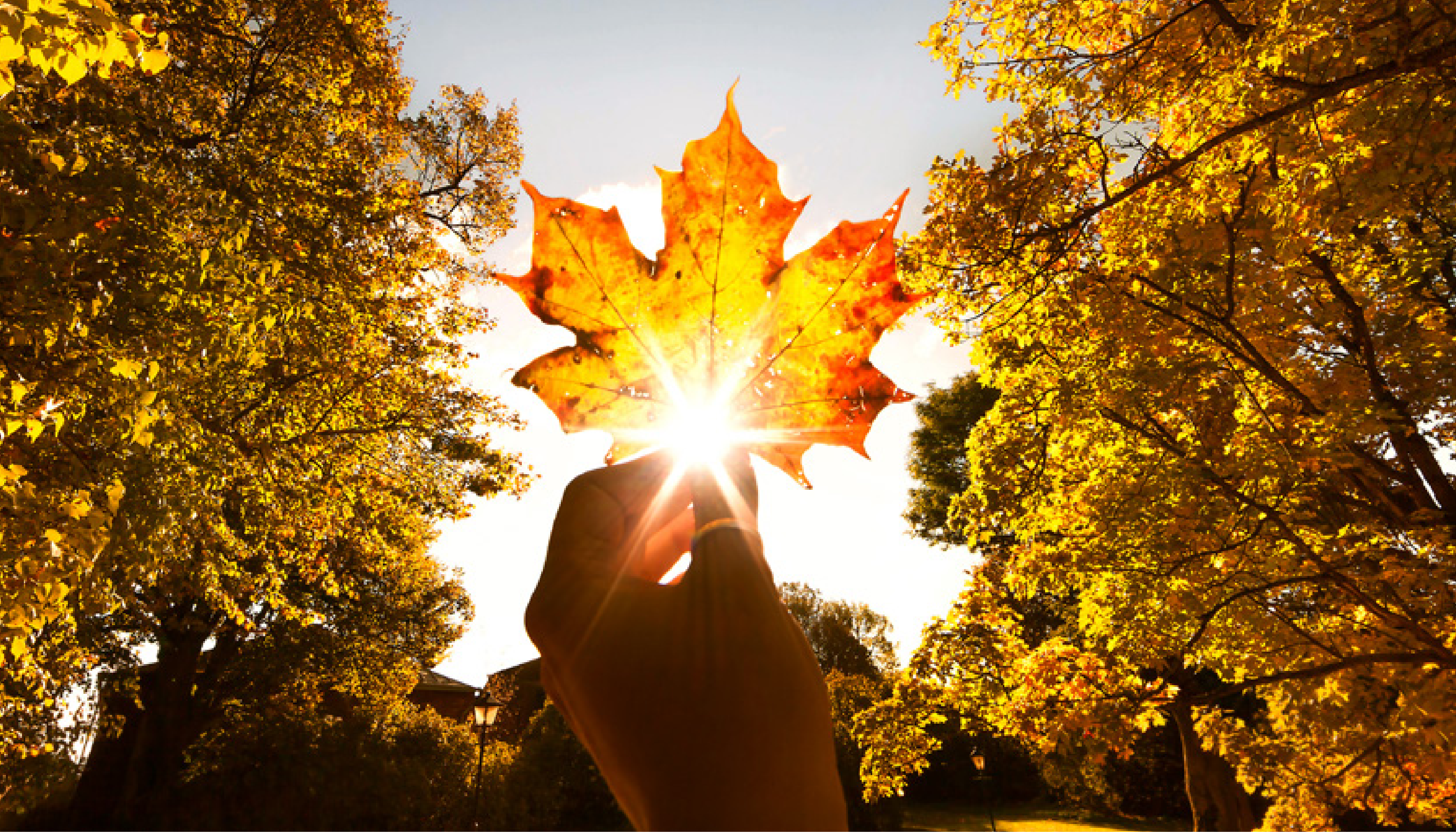


What are the typical exclusions in M&A policies?

- **Abandoned properties:** if a site is not being managed, redundant systems may be polluting the environment or trespassers can dump waste or fires could be started easily.
- **Material change in use:** significant changes in use, for example an office being redeveloped into a manufacturing plant, can significantly increase the environmental risk profile.
- **Voluntary site investigation:** policies will only pay for site investigations required as part of the M&A process or mandated by regulators.
- **Site redevelopment:** unless clearly part of pre-agreed business plan.
- **Employers liability and workers' compensation:** no cover for environmental health hazards claimed by employees.

PFAS exclusions

Polyfluoroalkyl Substances (PFAS) are synthetic chemicals used in non-stick, water repellent and heat/stain resistant products. They may be harmful due to the fact that they never break down. They can accumulate in the body if ingested and remain in the environment forever.

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. Clients should always consider buying longer-term cover to protect themselves against such emerging risks.

How does EIL help companies meet ESG challenges?

Increasingly, not having an ESG strategy puts businesses at risk of fines and reputational damage. By integrating environmental management processes with adequate environmental insurance, businesses can reduce their overall exposure and improve their ESG rating.

For example, having a rapid crisis response in place and the funds to clean-up immediately after an incident can reduce the extent of environmental damage and potentially lead to reduced regulatory fines and penalties.

EIL can also help manage emerging exposures. Industries that breach greenhouse gas emission thresholds could also face third party claims for damages as climate concerns continue to rise. Unlike other liability policies, EIL does not exclude climate-related environmental damage cause by long-term gradual emissions.

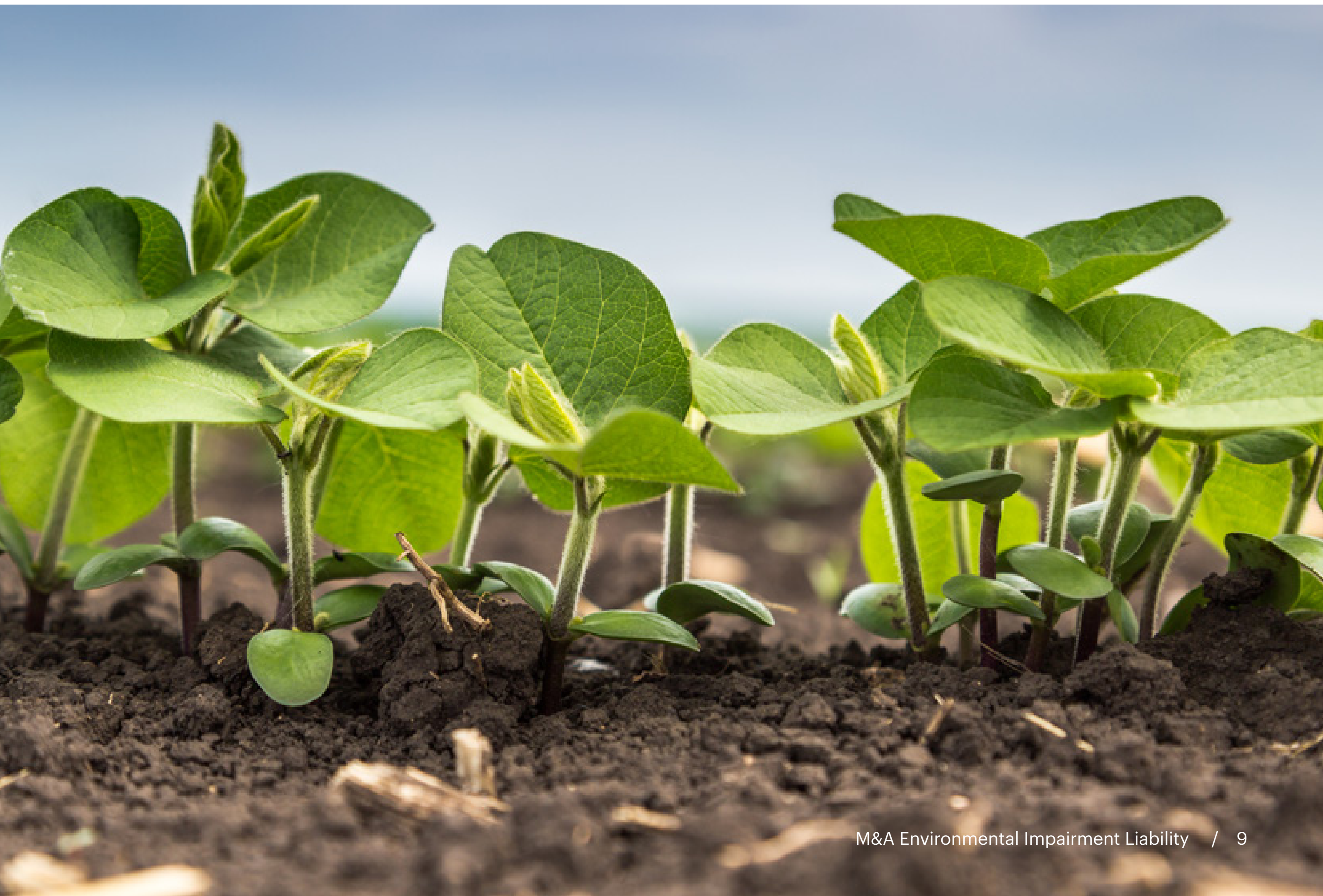
Tackling misconceptions and barriers to buying EIL

It's too expensive – depending on the risks involved, cover can be more affordable than people think. EIL can be much less expensive, and offer much higher limits, that the indemnity available from escrows.

We don't understand how this cover interacts with other policies – EIL covers the gaps in policies such as general liability and property but does not replicate those covers. There are clear triggers and responses with no blurring or overlap.

We don't think it's a big 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.

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.



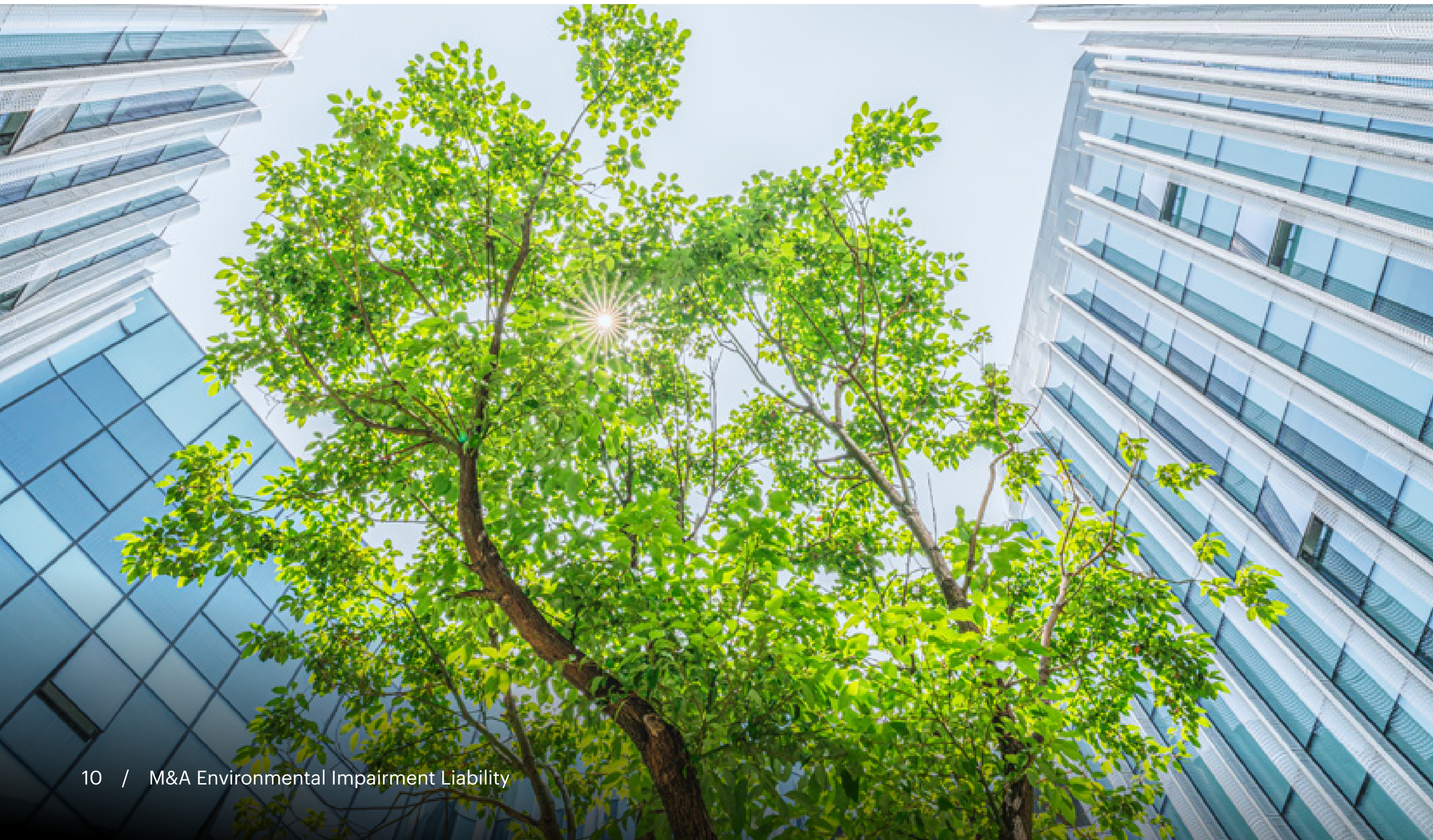
The market for environmental insurance

EIL was first sold more than 20 years ago and demand has been growing ever since – driven by publicity around major accidents, increasing legislative and regulatory controls, public pressure and concern over reputational damage. The market is now well established, especially in Asia, US, Australia, UK and Europe.

- U.S. market size is around $1 billion. Business is growing in Europe, with a market size of $100 million in the UK and $200 million in the EU.
- There are more than 60 insurers now involved globally, with 12 insurers active in the London market.
- Average capacity per loss is around $25m-50m, but we're seeing more clients buying higher limits, up to $250m.
- WTW has a specialist environmental practice. We can write bespoke wordings designed to cover specific risks associated with a contract or transaction.

Summary of key points

- EIL is designed to protect the seller or buyer against the financial impacts of pollution that pre-dates the transaction.
- Buyers can also buy cover for ongoing operations.
- It removes the need for collateral guarantees and escrows.
- Can cover all of the property and assets in a deal, providing location-specific cover.
- Insurance period can be up to 10 years.
- EIL pays for crisis response and mitigation, which can help reduce the impact of an incident and potential reputational damage.
- EIL cover can be assigned to a future buyer, which helps if the buyer wants to sell the business on.



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