

Managing Environmental Liabilities in Mergers and Acquisitions

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Environmental Risk Management Process



- Strategically simple
- Tactically complex

Risk Management Model



Environmental Professional

Environmental Site Assessments (Phase I)
 Past Land Use / Adjacent Land Use
 Waste Disposal Practices
 Regulatory Applicability Audits

Phase II Site Investigation
 Medial Sampling VOC's, Metals, PCB's..
 Identify Receptors On and Off site
 Determine Clean-up Standards

Regulatory vs. Institutional Controls
 Approved or Proposed Remedial Action Plan (RAP)
 Governmental/Regulatory NFA's Options
 VCP Programs, COC, IOP's...

Implement RAP / Perform Remedial Action
 Provide monthly/quarterly reports to Insurance Carriers
 Manage changes in the Scope, if any
 Obtain Conditional and/or Final Closure

Legal Professional

Environmental Regulations
 Federal Regulation – CERCLA, RCRA, CWA
 State Programs – PST, VCP's, IOP's
 Historical Regulatory Action

Legal Review of Regulatory and Contractual Issues
 Remediation Agreements
 Indemnification Agreements
 Criminal, Civil, NRD, Toxic Tort Exposures

Legal and Contractual Structure Options
 Use of Private Indemnification
 Remediation Agreement
 Flow of Funds Agreement

Execute Private and Public Indemnifications
 Flow of Funds Distribution
 Finalize Manuscripted Endorsements

Environmental Risk Manager - Broker / Carrier

Operations Exposures
 Waste Disposal Practices
 Transportation Issues
 Pre-Existing Conditions vs. On-Going Operations

Environmental Assessment Data
 Financial Statement Review
 Identify Stakeholders Issues
 Evaluate Uninsurable Risk

Risk Transfer / Management Options
 Applicable Insurance Products
 Pollution Legal Liability, Stop Loss, Finite
 Coverage Scope, Exclusion, Definitions, Security

Modify/Replace or Add to Existing Insurance
 Implement new Environmental Insurance Program
 Finalize Manuscripted Endorsements
 Oversee reporting and obligation to obtain closure

Elements of the Model



Identify

- Site assessments and regulatory applicability audits
- Environmental regulations and applicable state programs
- Operational exposures, disposal practices, transportation issues (potential sources of claims)
- Contractual, Contingent and Legacy exposures

Elements of the Model

(continued)



Evaluate

- Media sampling, identify receptors, determine clean-up standards
- Legal review of regulatory and contractual issues
- Financial review, identify stakeholders, review indemnification agreements
- Insurable vs. Uninsurable environmental risk

Elements of the Model

(continued)



Review

- Regulatory and institutional controls
- Legal and contractual
- Risk transfer/management, available products

Elements of the Model

(continued)



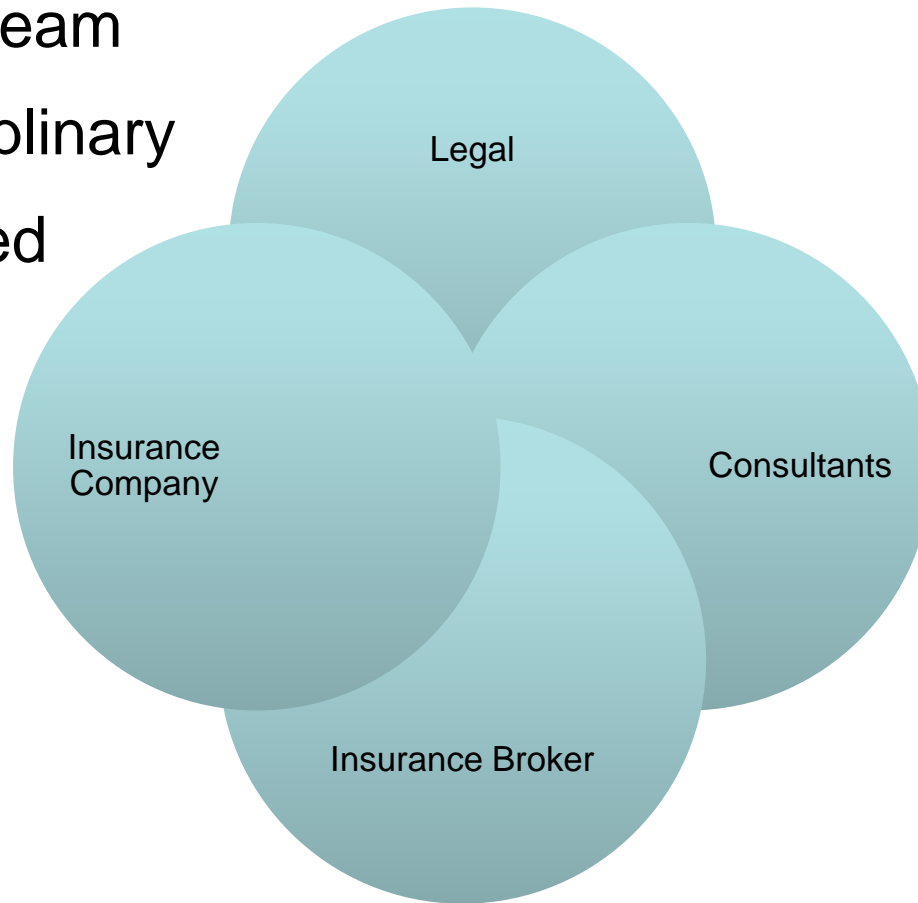
Implement

- Remediation, closure certificate, report to insurance company
- Use private indemnification, integrate contractual definition, finalize transaction funds
- Modify existing insurance, implement new environmental insurance program
- Oversee long term remediation, changes in scope and monthly/quarterly reporting


Focus on Environmental Liabilities

Transaction team

- Multi-disciplinary
- Inter-related



The Environmental Attorney's Role – The Project Quarterback



Legal Team

- Traditional Environmental Due Diligence
 - Compliance Assessment
 - Environmental Liability Risks
 - Spills, releases, agency enforcement, lawsuits, etc.
- Environmental Disclosure Due Diligence
 - Post Sarbanes-Oxley the Challenges have changed as acquisitions create new disclosure risks to the acquiring company
 - GAAP, SEC Regulations, Sarbanes-Oxley
- Growing Liability Risk Concerns for Corporate Officers and Directors

Changing Environmental Disclosure Requirements

Legal Team

- FAS 5
- Contingent Liabilities
- Asserted Claims
- Where uncertainty as to value, can report “low end of the range”
- Contamination results from improper operations or catastrophic release
- FAS 143/FIN 47
- Conditional Asset Retirement Obligations
- Legal obligations associated with asset retirement
- Fair Value—uncertainty built into estimate of value
- No “low end of the range”
- Contamination results from normal operations

SEC Regulations as Applied to Environmental Issues

Legal Team

SEC Regulation S-K 101 Description of Business


- Material capital expenditures for “environmental control facilities” such as Current fiscal year, Next fiscal year, and Other future periods, if material.

SEC Regulation S-K 103 Legal Proceedings

- Including lawsuits, administrative actions, or government enforcement proceedings)
- If material, or If a government agency is a party to the proceeding, and has filed or is contemplating action, and monetary sanctions are expected to be \$100,000 or more.

SEC Regulations

(continued)




Legal Team

SEC Regulation S-K 303 Management Discussion and Analysis

- Requires disclosure of “known trends, events or uncertainties” that may have a material effect on the company’s financial condition.
- 1989 SEC Interpretive Release states that S-K 103 applies to environmental trends and uncertainties such as: anticipated new regulations, and CERCLA liabilities.

Sarbanes-Oxley



Legal Team


Section 302

- Certification that the financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the “issuer.”

Section 404 Requirements

- Management of a public company will have to report annually on the effectiveness of the company’s internal control over financial reporting.
- Accounting firms must review and report on internal controls.

The 800 Pound Gorilla



Legal Team

Climate Change Due Diligence and Climate Change Disclosure

- Kyoto Protocol and EU restrictions on greenhouse gas emissions
- Northeastern States and Western States have enacted multi-state compacts to regulate carbon dioxide and other greenhouse
- Carbon footprint—greenhouse gas emissions now present a key environmental due diligence issue
- As regulations develop, climate change disclosure becomes ever more prominent for companies in many industries—utilities, refiners, mining, oil and gas, chemical, steel, cement, etc.

Project Overview

Consultants

Objectives

- Identify recognized environmental conditions
- Assess and prioritize risk associated with these conditions

Operational Constraints

- Time constraints will prevent full assessment

Solution

- Documented process agreed upon by acquisition team



The “Traditional” Review

Consultants

- ASTM Phase I or “All Appropriate Inquiries”
- ASTM Phase II, if necessary
- Review documentation associated with remediation projects
- Determine if there is any environmental litigation the company – pending or active
- Assess waste management practices
- Review environmental compliance
- Observe operating practices




Post Sarbanes-Oxley

Consultants

- Review SEC filings
- Existing environmental management system (EMS) – how are audit findings handled?
- Documented procedures for managing environmental liabilities and estimating costs?
- Documented procedures for identifying and assessing CAROs
- Status of greenhouse gas management program




What about the Costs?



Consultants

- Must define how and when cost to be estimated
- Consultant may be overly conservative during estimating process (i.e. defer to the high end of a range of possibilities)
- Conservative approach could result in an overstatement of liabilities and increase in required environmental reserves

Management of Disclosure Environmental Conditions



Insurance Broker

Post Sarbanes-Oxley

- Identifying Potential Environmental Liabilities
(See D&O Underwriting Questions)
- Disclosure Challenges

Identifying Potential Understated and/or Unknown Liabilities




Insurance Broker

- Have you been named as a Potential Responsible Party (PRP) under any state or federal Superfund law, with a contribution allocations / percentage in the past 10 years
- Are you currently under any environmental administrative order
- Are you currently being sued or in litigation for any environmental related circumstances
- Have you sold or divested any business in past 5-7 years with any known environmental liabilities/conditions
- Any SEC disclosures concerning environmental matters, including reserves for estimated cleanup, contaminated facilities, administrative orders, etc. Consistent with company specific data with the EPA's ECHO website.

Identifying Liabilities


(continued)



Insurance Broker

- Has your firm taken steps, specific to environmental matters, in response to recently adopted rules for executive attestation of internal controls, under section 404 of Sarbanes Oxley
- Are your recognized environmental cost associated with future Asset Retirements Obligations (ARO's, as required under FASB Statement No.143)
- Has your company received a request/comments on your MD&A concerning reporting liabilities, estimation method, assumptions used, etc. From SEC's Division of Corporation Finance (Fortune 500 only)
- Is the basis of your environmental reporting the low end of the range of estimated for your company's environmental liabilities, as prescribed by FASB FIN 14

Disclosure Challenges




Insurance Broker

- Environmental Insurance Coverage is written on “Claims Made Basis” coverage form requires accurate representation and warranties to be established
- Known vs. Unknown Environmental Conditions
- Expected vs. Unexpected Claims related Issues
- Conditions known and not disclosed ARE NOT COVERED
- Insuring the Burning Building – “known conditions” that could become a future claim

Disclosure Challenges


(continued)



Insurance Broker

- Applications, Disclosure and Warranties are very important documents
- Management of large amounts of very technical data
- Critical to document and communicate information via disclosed “data management systems / spreadsheet

Underwriting



Insurance
Company

Identify / Quantify “Known” Liabilities

- Cleanup
- 3rd Party BI & PD
- NODS (PRP)
- Fines, Penalties, Punitive Damages
- Natural Resource Damages
- Contractual Liability
- Previously Divested Sites

Underwriting


(continued)

Insurance
Company

Identify Potential “Unknown” Sources of Liability

- Non-Owned Disposal Sites (NODS)
- Natural Resource Damages (NRD)
- Regulatory Fines, Penalties & Punitive Damages
- Business Interruption
- Development Soft Costs
- Representations and Warranties
- Transportation
- Previously Divested Sites

Known Conditions




Insurance
Company

Known Contamination	Impact to Coverage
<ul style="list-style-type: none">• Well Delineated Remediation Plan in Place	<ul style="list-style-type: none">• Coverage for 3rd Party BI & PD• Coverage for off-site cleanup• Cost Overrun Coverage
<ul style="list-style-type: none">• Below Risk-based cleanup threshold• NFA / NFR granted	<ul style="list-style-type: none">• Cleanup coverage with Government order trigger

Known Conditions

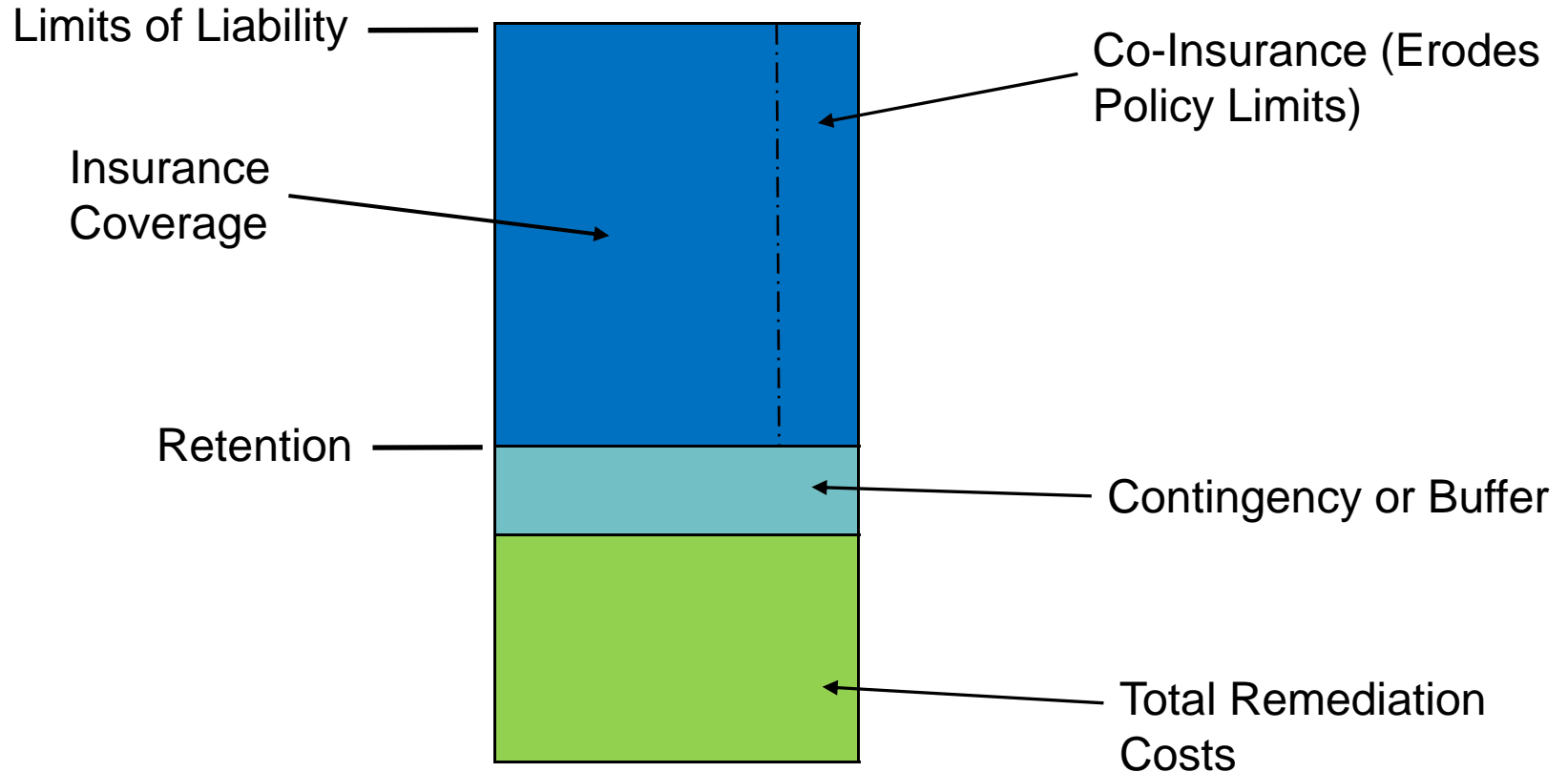
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Insurance
Company

Known Contamination	Impact to Coverage
<ul style="list-style-type: none">• Managed with Institutional or Engineering Controls	<ul style="list-style-type: none">• Violation of Institutional or Eng. Controls
<ul style="list-style-type: none">• Monitored Natural Attenuation	<ul style="list-style-type: none">• Gov. Order Cleanup w/ Monitoring and Testing exclusion
<ul style="list-style-type: none">• Indemnification Provided by another responsible party	<ul style="list-style-type: none">• Full coverage excess of the Indemnity

Stop Loss Coverage



- Multi-year policy to coincide with project length
- Claims-made coverage; policy expires at project completion

The Take Away

- The management of environmental liabilities during a merger or acquisition has become more complex since Sarbanes Oxley
- Requires a cross-functional team that understands the implications of the Act
- Legal – Beyond traditional environmental issues, should evaluate potential affect on future securities disclosures and impact of future climate change legislation.
- Consulting – In addition to identification of “traditional” liabilities, should also assess CAROs and GHG management, and complete liability estimates in a manner consistent with GAAP.
- Brokerage –
- Insurance – Engage Insurer early and clearly define the goals and schedule required of the risk transfer program