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Environmental Due Diligence in a Competitive Mergers and Acquisition Market



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Driven by low interest rates, large corporate cash reserves, and a steady and sustained rise in the stock market, the aggressive mergers and acquisitions market of 2014 appears poised to charge full steam ahead into the new year.

The increased competition for deals across a number of business sectors means that there is no guarantee that prospective buyers will secure deals even with bid offers with high cash flow multiples. Prospective buyers face a number of challenges in this competitive environment, including truncated diligence time frames, multi-party competitive auctions, and seller-friendly contract terms.

To respond to these challenges, buyers are well-advised to adjust traditional environmental due diligence models to focus on obtaining critical information at critical junctures in the transaction process. Experienced environmental advisers can play a major role in fine-tuning that process in support of the deal.

In this article, we examine the role that environmental advisers can play in developing an effective environ-

mental due diligence plan that reflects the current realities of the mergers and acquisitions. We examine threshold questions to address early in the diligence process and discuss some risk-mitigation tools to keep in mind while moving, often very quickly, through the diligence process.

The Role of Environmental Advisers. Environmental issues can significantly affect the valuation of a deal for a prospective buyer. Experienced environmental attorneys and consultants are likely to understand the context of business transactions and their role in supporting a prospective buyer's desire to pursue a deal. They can provide practical advice to address environmental concerns discovered in diligence.

They will also understand the importance of "making a good impression" with the seller in a competitive bidding environment. Experienced advisers, for example, understand how to communicate efficiently with the seller's representatives and can focus their questions to elicit a deeper understanding of material issues, in lieu of pro forma environmental, health and safety diligence questions that may have limited applicability to the target company's business.

Getting off to a Good Start. At the outset, the prospective buyer and environmental counsel should address the following issues:

- What is the materiality threshold for environmental issues?
- Which type of site assessment should be conducted at various stages of the diligence process?
- Who should review the documents in the seller's virtual data room?
- How should diligence information be presented to the prospective buyer (written reports, excel spreadsheets, verbally)?

Setting the Materiality Threshold. Materiality can vary based on the transaction size and the risk appetite of the prospective buyer and finances of the deal. The environmental review must be calibrated to take this into account. Understanding the types of liabilities or magnitudes of costs that the prospective buyer may consider to be showstoppers will help inform the approach to diligence. In some cases, environmental costs below \$100,000 may be material to the deal. In other cases, materiality may be set substantially higher. Regardless of the threshold that is determined, experienced environmental advisers know to flag environmental concerns that individually may fall below the threshold, but in the aggregate may present a material issue.

Environmental Site Assessments, Diligence Reports. Customary actions are Phase I environmental site assessments, which provide an overview of recognized environmental conditions at a site through evaluation of publicly available records, a site inspection with a focus on operations at the site and the condition of the property, and interviews with owners/occupants. Other diligence reviews and reports may be useful to the prospective buyer, depending on the environmental risk profile of the target company's business and the stage in the bidding process. A tiered plan that includes combinations of the approaches below may be appropriate depending on the specific environmental concerns associated with the target company and the structure and length of the diligence phase:

- **"Red Flag" Review.** A "red flag" review is a relatively high-level review of data room materials, and possibly other sources, to identify potentially significant findings or areas of concern. As discussed above, it is important to have a discussion early in the diligence process to define what would constitute a "red flag" or "very material" environmental issue. Materiality at this stage may be higher than at later stages because "very material" concerns will need to be taken into consideration early in the process.

- **Desktop Review.** The desktop review typically includes a thorough review of data room materials, a management interview, a review of publicly available sources of information, a review of information from third-party providers such as environmental data resources regulatory database searches and historical information, and preparation of a report. As a facet of the desktop review, especially for a buyer that may intend to operate at the site for some time, the environmental consultants should consider corporate history research to understand past entities to whom environmental li-

abilities may be traced and environmental conditions that may be associated with the operations of prior entities. The desktop review can be a useful tool in multi-party bidding situations where site visits may not be permitted by the seller as well as to better understand issues raised in the red-flag review and potentially provide input to financial models.

- **Compliance Review.** Depending on the type of operations conducted by the target company, a review of compliance with environmental, and possibly health & safety, regulations may provide significant benefit in the due diligence process. Such reviews can be performed in conjunction with a Phase I environmental site assessment and provide an assessment of the target company's overall environmental compliance. These types of reviews often include an assessment of the quality of the target company's environmental management system, which in turn can give an indication of the potential for undiscovered compliance violations. The information from the compliance review can be used to develop cost estimates for potential regulatory violations.

- **Phase I Site Assessment.** Phase I environmental site assessments may be appropriate to conduct at all of the target's properties, or possibly only at a subset of the properties. These investigations can range in price from \$3,000 to \$15,000 per site, so it is important to be strategic in determining which properties to investigate in the case of a target company with multiple sites. In selecting sites to visit as part of the Phase I evaluation, the focus should be on present manufacturing or industrial facilities, sites formerly operated as manufacturing or industrial facilities, or on those with a complex environmental history as understood through a review of the virtual data room. Additionally, the prospective buyer should consider whether lenders will require a Phase I site assessment.

- **Phase II Site Assessment.** In some cases, it may be advantageous to perform sampling of environmental media at a site as part of due diligence activities. Such Phase II site assessment activities may involve the installation of groundwater monitoring wells; collections of samples of groundwater, soil, air, or other media; laboratory analysis of samples for the presence of chemical or petroleum contamination, and the comparison of results with appropriate standards. Phase II site assessment activities are undertaken in a transactional context to confirm the presence or absence of contamination, set baseline conditions before acquiring a site, or reduce the uncertainty associated with previously developed cost estimates. Planning for and performing Phase II activities, however, may add several weeks to the due diligence process and significant costs (often in the range of \$15,000 to \$50,000 per site), and expose the parties to possible reporting requirements that might apply if contamination is detected.

Cost Estimates. Working together, an environmental attorney and environmental consultant can develop cost estimates, often in the form of ranges (or point estimates representing varying probabilities of occurrence), to address environmental issues that have been identified in the course of diligence. These estimates also may be developed based on the desktop review but can be more useful when they are prepared after a Phase I assessment and/or compliance review is per-

formed. The components of these costs estimates typically are:

- remediation costs associated with known and potential contamination issues,
- capital expenditures required to achieve regulatory compliance or bring equipment in line with the buyer's best practices,
- financial assurance obligations for the target company's environmental obligations that the prospective buyer will need to assume post-closing,
- environmental health and safety litigation (toxic tort, worker exposure claims), both pending and potential,
- environmental health and safety personnel expenditures required post-closing if it is not possible or desired for the target company's environmental health and safety management team to remain in place after the closing and
- regulatory penalties associated with known and potential enforcement for noncompliance with environmental laws.

Conquering the Virtual Data Room. As early as possible, environmental counsel and the technical consultant should discuss a strategy to review documents in the virtual data room, with a goal of ensuring that all of the information is carefully reviewed and analyzed while avoiding unnecessary duplication of efforts. A logical initial allocation of responsibilities could entail the environmental consultants focusing on technical and remediation documents and the legal team evaluating documents related to regulatory compliance, environmental enforcement, litigation and contractual allocations of environmental liabilities, such as in customer contracts, real estate leases and corporate acquisition documents.

As a matter of process, environmental consultants should flag for further legal review any documents that may have broader implications to the valuation of the company, specific environmental liabilities, and other general concerns. Discussing this division of labor and client expectations regarding the review should occur

early in the process to avoid misunderstandings and cost overruns.

Looking Beyond the Virtual Data Room. In addition to conducting a desktop review, environmental advisers can mine other public sources to identify potential environmental risks associated with the target company and the industry in which it operates. For example, if the target company is a chemical manufacturer, the due diligence plan should include a regulatory review of the chemicals sold and rulemaking activity at the federal, state and local level that could impact the ability to sell or distribute the chemicals.

More broadly, a consideration of regulatory risks should encompass not only environmental, health and safety regulatory compliance, but also product safety and product compliance, such as Proposition 65 in California and the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) in Europe. Additionally, consideration of industry-specific regulatory enforcement initiatives will aid in highlighting potential environmental liabilities that may loom on the horizon.

Developing Diligence Information for Post-Closing Use. Environmental advisers should also use the diligence period to identify potential risk mitigation tools for environmental issues that have been identified. For example, the diligence process may yield findings appropriate for disclosure under state agencies' and EPA's self-disclosure policies that could considerably mitigate environmental liabilities and penalty exposure.

Specifically, EPA's self-audit policy for new owners issued in August, "Interim Approach to Applying the Audit Policy to New Owners," unlike its counterpart for existing owners, remains an active program that can help new owners of companies avoid hefty statutory penalties for violations disclosed in compliance with EPA's policy (73 Fed. Reg. 44,991).

To qualify for the benefits of EPA's New Owner Policy, however, self-disclosures must be made within a relatively short time frame following the transaction and the discovery of noncompliance. Such strategic considerations can have significant impacts on post-closing costs and should be discussed during the diligence phase.