

**ADDRESSING ENVIRONMENTAL ISSUES
IN THE ACQUISITION OF OPERATING
ASSETS FROM FINANCIALLY
DISTRESSED SELLERS**

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Over the past two years in Texas, we have had a front row seat watching oil companies get hammered by the rapid fall and subsequent instability of crude oil prices. More recently, coal companies are feeling the dual effect of losing market share as a result of lower natural gas prices and the regulatory assault on coal-fired power plants. Companies are facing significant financial pressures from, among other things, over-leveraged balance sheets, shrinking asset valuations that reduce their borrowing base, and depressed commodity prices. As a result, the energy industry is undergoing restructuring, and opportunistic buyers with available cash reserves, or access to capital markets to borrow funds, are looking to purchase operating assets at fire sale prices.

Given the speed at which a company's financial outlook can change in today's market place, a buyer of operating assets in any industrial or commercial sector is well advised to consider the seller's financial ability to meet contractual obligations that the seller undertakes in selling assets, even if there is not a current concern about the seller's financial wherewithal.

This paper was prepared in connection with an interactive presentation at the 28th Annual Texas Environmental Superconference by the author and Joe Wielebinski. The outline below summarizes various matters relating to potential environmental liabilities and risks that a buyer should keep in mind when planning to acquire operating assets. It also highlights strategies a buyer should consider when making an acquisition from a financially distressed seller. Issues and considerations arising out of a seller's insolvency and bankruptcy are addressed in the companion paper to this outline included in conference materials entitled "*Distressed Asset Sales in Bankruptcy*," co-authored by Mary Koks, Joseph J. Wielebinski and Ruth Brenton.

I. OVERVIEW OF ENVIRONMENTAL OBLIGATIONS.

- A. Buyers of operating assets will have concerns due to the broad coverage and complexity of environmental, health, and safety laws and regulations at federal, state and local levels. Obligations can arise from historic operations and property use and from future operations.
 - 1. *Remedial liabilities* impose cleanup obligations based on "status" without regard to fault. Categories of "responsible parties" can include current owners and operators of property, former owners and operators of property (including previously divested property), and parties that generate or arrange for disposal of waste materials. Remedial liabilities can have the potential of exceeding the value of the assets acquired.

2. *Operating requirements* can impact a buyer's ability to operate the assets it purchases. Continued operations usually require permits or other approvals of governmental authorities or third parties that need to be transferred or otherwise obtained. Regulatory requirements may also restrict expansion of current operations.
 3. *Tort liabilities* for property damage to third parties can arise from migrating contamination. Third party claims may also be asserted for injury caused by exposure to chemicals or from operations at the sites to be acquired.
 4. *Other liabilities* can arise out of noncompliance with applicable statutes and regulations. Depending upon how a transaction has been structured, a buyer may be subject to fines or penalties for its predecessor's noncompliance with operating, monitoring, reporting and recordkeeping requirements. Noncompliance with permitting or other regulatory requirements can also result in forced shutdown or curtailment of noncomplying operations.
- B. Buyers deal with potential environmental concerns primarily using two approaches :
1. *Prepurchase due diligence investigation* is used by a buyer to understand historical operations and property conditions at the assets. This investigation process will help the buyer identify liabilities and risks and assess compliance with operating requirements relating to the assets. That process can also serve to develop information that buyer can use to support its request for price concessions from seller.
 2. *Contractual allocation* provisions specify the responsibility of seller and buyer for various known and unknown environmental liabilities and risks. Note that the contractual allocation is between buyer and seller and does not bind a third party, including governmental entities, that may have claims, unless the third party agrees to that allocation.

II. IDENTIFYING ENVIRONMENTAL OBLIGATIONS.

- A. The environmental assessment process used for *pre-acquisition due diligence* involves a series of steps to identify *environmental liabilities* (that is, known or expected obligations or expenses based on known conditions) and to attempt to determine *environmental risks* (that is, potential exposures based on known or unknown conditions) arising out of current and historic site conditions and operations. Data gaps, where historical information is not available, can present a challenge.

- B. Scoping the assessment is a deal-critical task. The scoping process for pre-acquisition due diligence will take into consideration the following:
1. What documentation is to be reviewed and what sites are to be visited.
 2. The issues to be covered in consultant's report.
 3. Interface between consultant and representatives of seller and buyer.
 4. The staffing and timetable for the component parts of the assessment.
 5. Whether subsurface or other sampling will be performed.
 6. Concerns involving confidentiality issues and seller's sensitivities to discussion with governmental authorities.
 7. Availability of existing information in seller's files and buyer's access to and ability to rely on those materials.
- C. The goal of the assessment is to determine existing or potential problems that provide information from which buyer can assess potential liabilities and risks, establish ranges for any remediation it deems necessary or appropriate, and negotiate the deal. It involves legal, technical, financial, and business risk judgments and involves balancing the up-front time and investigative costs against the potential later expense arising out of undiscovered conditions.
- D. Two types of environmental assessments are commonly used to investigate property.
1. *Phase I site assessments* involve a review of aerial photos, documentary review, interviews, and site visits to evaluate the potential for environmental conditions. A Phase I site assessment is a qualitative, not a quantitative, exercise.
 2. *Phase II site investigations* involve physical testing, including subsurface sampling of soil and groundwater, to determine if property has been environmentally impacted. A Phase II site investigation provides quantitative information, but its ability to adequately quantify environmental costs is highly dependent on its scope.
- E. *Operations assessments* are also used to determine compliance of existing operations with applicable environmental, health, and safety laws and regulations, including permitting requirements.
- F. *Property condition assessments* are performed to identify the physical condition of buildings and building systems (such as heating and air conditioning, electrical and plumbing) along with other improvements. These types of assessments are separate from the environmentally-related assessments, but may also involve health and safety components as well as analysis of building code compliance.

- G. The results of the assessments are set forth in reports prepared by the consultant that performed the work and best practice is to have the reports reviewed by the environmental attorney in draft form before the reports are finalized. The assessment process may also identify what data and other information are not available.
- H. The assessment process can provide a basis for negotiating the structure and the price of the transaction. It can also provide a baseline analysis of existing property conditions and operating status where the contractual agreement provides those conditions to determine the post-closing obligations of seller or buyer.

III. ALLOCATING ENVIRONMENTAL LIABILITIES AND RISKS.

- A. Information from environmental assessments can be used to determine how to negotiate the allocation, by contract, of environmental liabilities and risks between buyer and seller. Among the matters considered are the following:
 - 1. What are the actual liabilities identified (such as identified contamination or exposure to third party claims)? What are the real risks of exposure to liability?
 - 2. Can a dollar value or possible range of dollar values be assigned to potential exposure? What kind of valuation adjustments should be made for assets with known contamination?
 - 3. Will seller retain liability for pre-purchase environmental issues? If so, will seller be liable if buyer undertakes a voluntary response to avoid potential liabilities that may arise from the presence of a substance on property or only if there is a legally mandated clean-up requirement?
- B. The *deal structure* can help reduce the potential for environmental exposure of buyer.
 - 1. An *asset deal* involving the acquisition of specified assets, without the assumption of seller's liabilities, is usually the best method of shielding buyer from environmental liabilities and risk.
 - a. The protection may be enhanced when buyer forms an adequately-capitalized single purpose entity that is separately operated to make the acquisition, so that if environmental obligations are later deemed to have followed the assets, those obligations are at a subsidiary, not parent, level.

- b. In a multi-property asset deal, the parties may agree to exclude properties with environmental problems from the assets to be transferred.
 2. In a merger, two entities are combined into one. As a result, the assets of the acquired entity as well as the liabilities and obligations of the acquired entity become those of the surviving entity.
 3. In a stock purchase, buyer becomes the parent of the newly acquired subsidiary entity. Note that there are various legal theories, referred to as indirect liability and direct liability under existing case law, under which a parent entity may be found liable for the liabilities of the subsidiary entity.
 4. No particular deal structure should be assumed to provide buyer with bulletproof protection from environmental issues.
 5. Structure issues need to be considered as part of the deal as a whole, and tax and other considerations, rather than environmental concerns, will ultimately determine the form in which the transaction is structured.
- C. There are a number of contractual provisions a buyer may use to protect itself from loss in a transaction.
 1. The representations and warranties (with related disclosure schedules) in the acquisition agreement are intended to provide additional information to buyer about environmental issues.
 - a. Representations and warranties may be considered to serve a dual purpose:
 - (i) providing disclosure from seller to buyer about the operations being acquired, and,
 - (ii) acting as an additional risk allocation mechanism by providing remedies to buyer if the disclosure is incorrect.
 - b. Some buyers may choose to minimize the prepurchase due diligence process and rely upon the seller's representations and warranties instead. The success of that approach will depend upon both adequate contractual remedies for buyer if seller's representations and warranties later prove to be false or misleading, and seller's financial wherewithal to meet monetary obligations under the remedies to which it has agreed in the acquisition documents.

2. *Indemnification* provisions in the acquisition documents can be used to provide buyer with financial protection with respect to specified conditions or events.
 - a. Indemnification provisions can clarify which party is responsible for conditions impacting the operations acquired and claims or losses relating to those conditions or for the operations generally, particularly with regard to pre-existing environmental conditions and obligations arising therefrom
 - b. There is no "standard" form of indemnification. Contractual indemnity provisions are typically highly negotiated. They can work in a complimentary fashion with the representations, warranties and covenants sections of the acquisition documents, or they can stand alone.
 - c. Buyer should identify and quantify (to the extent possible) the environmental liabilities and risks to determine the potential costs associated with those liabilities and risks before negotiating the scope of the indemnification.
 - d. An environmental consultant may be able to provide a range of costs associated with remediation of particular site conditions, but recognize that this estimation process will generally be based on a set of assumptions which, if incorrect, could result in material underestimation of the actual costs of remediation.
3. In a *remediation agreement*, one of the transactional parties, often seller, can agree to perform specified post-closing obligations.
 - a. This is particularly useful in addressing the remediation of known pre-closing environmental conditions.
 - b. Among the provisions commonly found in a remediation agreement where seller is performing the obligations are the following:
 - (i) access (since seller will no longer control the asset being remediated).
 - (ii) required clean-up standards and regulatory closure program acceptable to buyer.
 - (iii) contractor qualifications.

- (iv) schedule for completion of work and damages in case of delay.
 - (v) a definition of seller's remediation default under the remediation agreement and a mechanism for buyer's remedies in such an event.
 - (vi) insurance.
 - (vii) indemnity against claims or damages arising out of the remedial work.
- c. Escrow arrangements are many times used to fund the remediation obligations.
- (i) Seller can draw on the escrowed funds to reimburse it for the cost of performing the work.
 - (ii) Buyer will want to also have access to the escrowed funds in the event of seller defaults in performing the obligations required in the remediation agreement.
- D. The protection provided by the contractual risk allocation provisions described above will depend on the financial ability of the obligor to perform its contractual obligation.
1. If seller provides buyer with an indemnity, buyer is only protected if seller has the financial wherewithal to satisfy that obligation at the time that buyer, as the indemnified party, makes a claim.
 2. Consequently, a buyer making an acquisition from a distressed seller should consider strategies that will allow a response to the contractual obligation irrespective of the indemnitor's financial position at the time the indemnification claim is made.
 3. Strategies that may be used to address concerns about the seller's future ability to fulfill any contractual obligation include the following:
 - a. *Escrow arrangements* set aside monies (usually a portion of the purchase price seller would otherwise receive) with a third party, which will then disburse those monies when certain milestones are met, in the case of seller performing contractual remediation obligations, or if claims are made, in the case of indemnification obligations.
 - b. *Purchase price holdbacks* by buyer allow buyer to effectively act as the escrow agent and retain monies if milestones are not met or to satisfy indemnity and other post-closing claims.

- c. Pledges of additional collateral by seller give buyer a security interest in assets other than the assets it is purchasing in order to secure seller's contractual obligations.
 - d. Guarantees by seller's principals or other affiliates allow buyer to look to the assets of affiliates of seller in the event seller does not have the financial wherewithal to perform its contractual obligations.
4. The post-closing insolvency or bankruptcy of seller or affiliated parties can jeopardize the protections provided under the strategies noted above.
- E. Buyer can also use third party obligations to provide primary or supplemental protection from environmental liabilities and risks.
- 1. Letters of credit and other third party financial guarantees of payment can be used to secure seller's contractual obligations with a third party agreeing to assume the risk, for a fee, of seller not performing its contractual obligations.
 - 2. Environmental insurance can also be used to protect buyer since an insurance company would be expected to have the financial wherewithal to fulfill its policy obligations.
 - a. Pollution liability policies can provide coverage for investigation and cleanup costs, bodily injury, property damage, natural resource damages assessments, and loss of business income.
 - (i) Coverage usually will not extend to cleanup of certain "known" conditions, thus not providing coverage for remediation of the issues that are the primary concern to buyer. Coverage may not be available at all where the contamination has not been fully delineated or the government has not approved a remedial plan. Coverage for third party claims for bodily injury or property damage may be available even for "known" conditions. Where "known" conditions exist, it is sometimes easier to quantify the potential costs of cleanup than the potential costs of tort liability. In these situations, pollution liability insurance may be paired with remediation agreements, escrows, letters of credit or purchase price holdbacks and possibly cost cap insurance to effectively manage "known" conditions risks.
 - (ii) While buyer may consider insurance as an alternate to a seller indemnification obligation, it needs to keep in mind that an insurance policy is written with limits on the duration and dollar amount of coverage provided, has certain significant exclusions,

and may not be renewable at the end of its stated term. Also multi-year policies do not reinstate limits annually.

- (iii) Some environmental insurers will write policies on an “excess of indemnity” basis, where the policy is structured to respond to certain situations where seller’s indemnification obligation has been exhausted.
- b. *Cost cap policies* provide coverage to protect against cost overruns in remedial projects.
- (i) Policies are underwritten based upon an expected budget for cleanup work, usually once a remediation plan has been approved by regulators.
 - (ii) Policies are to pay out, up to the policy limits purchased, if the actual costs exceed the budgeted costs plus a negotiated buffer amount (expressed as a percentage of budgeted costs or specific dollar amount). When the policy begins paying in excess of the buffer amount, the insured will also have a co-payment obligation up to the limits purchased.
 - (iii) There is a very limited market of underwriters willing to write cost cap insurance, and policies are available only for larger remediation projects. The few insurers remaining in the market generally have minimum premiums at or above \$200,000 and limits available tend to be less than \$5 million.
3. *Environmental liability buyouts* may be utilized where buyer is unwilling to assume full financial responsibility for cleanup of specified known environmental liabilities and related liabilities and risks.
- a. Buyouts utilize a third party company that agrees to complete the cleanup and assume certain defined liabilities and risks, generally in exchange for an upfront lump sum payment.
 - b. The buyout company may utilize a variety of mechanisms to assure performance, including segregated escrow or trust funds, pollution liability and cost cap insurance, indemnities, corporate guarantees, cost-sharing agreements, and performance bonds.
 - c. In a true environmental liability buy-out, the obligations assumed by the buyout company are unlimited as to amount, duration, and scope of

environmental remediation obligations and backed by the balance sheet of the buyout company's parent corporation.

- d. Where sellers have no buyer for the asset being disposed of, a buyout firm may take title to the real estate and use its value as part of the consideration for the transaction, generally where the asset has some commercial real estate value.
4. Guaranteed fixed-price remediation (GFPR) contracts operate similarly to environmental liability buy-outs, where a party transfers its remediation obligations to an environmental remediation firm for a single, lump-sum payment.
- a. In a GFPR, the remediation obligations assumed by the environmental firm are often capped at a specific dollar amount and may be limited to the specific scope of work agreed between the parties.
 - b. The environmental firm assuming the remediation obligations under a GFPR may use some or all of the same risk transfer mechanisms to assure performance as environmental liability buy-out firms.

IV. WRAP UP

In a deal involving a financially distressed seller, contractual provisions typically used to allocate environmental liabilities and risk, namely contractual indemnification obligations and representations and warranties, may not provide adequate protection to a buyer. That will put more emphasis on buyer's performing pre-acquisition due diligence assessment that is thorough enough to identify the material environmental liabilities and risks arising out of a proposed transaction. A buyer should consider strategies that can protect it without regard to seller's financial position post-closing, such as using escrows, guarantees and pledges of collateral for protection against the risk of seller's inability to perform post-acquisition contractual obligations. Buyers may also be able to utilize the financial wherewithal of third parties to provide additional protection to buyer against such risks. But a buyer needs to keep in mind that even the best laid plans may be upset by the later insolvency or bankruptcy of seller or affiliated parties.

This paper was prepared in July 2016 as a general discussion of the issues presented. It is not to serve as, or to be relied upon as, legal advice. The views expressed in the paper are those of the author, and not of my law firm or its clients.