ENVIRONMENTAL RISKS

Environmental Risks Can Be M&A Hazards

By **E.E. Mazier**

Take nothing for granted or at face value, and asks lots of questions. These were the watchwords delivered at a seminar on environmental solutions for mergers and acquisitions recently sponsored by insurance broker Marsh in New York.

According to John L. Cusack, senior vice president for Marsh Environmental Solutions, statistics show that 70 percent of mergers and acquisitions fail.

Peter B. Walther, managing director of Marsh Private Equity and M&A Services, added that not only has the rate of M&A activity slowed since 2000, but also that the Enron scandal has made buyers and their financiers skittish about risk.

For a buyer who wants a successful merger or acquisition, one important element of the deal is to quantify the environmental liabilities, Mr. Cusack said. Contamination affects the value of a property and the reputation of a company, he stated. Moreover, the more certainty a buyer has about the risks and liabilities it is undertaking, the more favorable financing terms it will find.

Daniel R. Lavoie, senior vice president and environmental group leader in Marsh Inc.'s New York office, who served as panel moderator, discussed some of the many insurance options available for handling environmental issues in merger and acquisition transactions.

For unknown environmental risks, the most widely used policy is the pollution legal liability policy, which goes by several other names in the marketplace, he said. The policy provides first- and third-party protection for sudden and gradual releases from new and pre-existing contaminants.

Sixty-five percent of all cleanups exceed budget by at least 10 percent, according to Marsh expert

Legal defense coverage is another important feature of the policy, given the rising legal costs in environmental litigation, Mr. Lavoie said.

Other coverages under a pollution legal liability policy can include first-party business interruption expense, diminution of value of the site, natural resource damage restoration costs, and liability coverage related to the governmental reopening of a pollution case against a company, he stated.

The major benefit of the pollution liability policy is the rapid decision-making in the underwriting process as well as flexibility in scope and pricing, Mr. Lavoie said. Underwriters understand that every merger deal is unique, and they are willing to suggest creative solutions to suit the client and the particular transaction, he stated.

For known environmental issues, Mr. Lavoie said, remediation cost cap or stop loss insurance is a desirable option. He emphasized this point by noting that 65 percent of all environmental cleanups exceed budget by at least 10 percent.

A cost cap policy can be an acceptable alternative form of financial assurance to support indemnities and releases exchanged in a merger or acquisition, Mr. Lavoie said. It also can cover cost overruns related to the transportation and disposal of waste, the discovery of unknown and pre-existing contamination and natural resource damage restoration.

For Mr. Lavoie, the major benefit of a cost cap policy is that it transforms the uncertainty of environmental cleanup costs into a manageable, finite number.

But because the cost cap policy lacks a liability component, Mr. Lavoie said, Marsh often counsels its clients to merge the pollution liability policies with the cost cap policies to take care of both known and unknown risks.

Another available tool is secured creditor coverage, Mr. Lavoie stated. It protects lenders for loss arising from default of commercial real estate loans made on properties that have an environmental condition. The coverage also gives the lender third-party liability coverage for bodily injury, property damage and cleanup costs associated with a default, Mr. Lavoie said.

One benefit of secured creditor coverage is that it can be used in large securitizations to improve a company's credit

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Privately held agencies typically trade between nine- and 15-times after-tax earnings. Publicly held brokers are trading above their historical highs, and are experiencing P/E ratios in the range of 23 to 34.

For example, assume a publicly held broker buys an agency at 12 times after-tax earnings and has a P/E ratio of 25. Upon the consummation of the transaction, the value of the agency to the broker has effectively doubled on a cash flow earnings per share basis because the purchased agency's after-tax earnings multiple (P/E ratio) jumped from 12 to 25. This "private to public multiple arbitrage" is at a high point, driving the interest of public brokers to quickly consummate acquisitions.

Public brokers have a pipeline of agencies they visit on an intermittent basis. An enormous amount of time, energy and money has been invested wooing, qualifying, indoctrinating and developing these relationships. For many reasons, public brokers have not historically paid the kinds of prices banks are now paying for foundation acquisitions. Despite the relationship, the price difference has caused many brokers to miss opportunities with high quality sellers.

Dashed hopes and inflated public broker P/E multiples have forced and allowed public brokers to be much more competitive in pricing. Brokers have quickly learned that they must be willing to "pay to play" to avoid losing a quality agency deal to another buying segment. They are now paying higher multiples for acquisitions relative to banks making subsequent acquisitions. The average price paid by brokers in 2001 was 1.71 times revenues.

Because of the aggressive consolidation in the insurance arena, the number of available agencies will continue to dwindle. Understanding each buying segment and knowing how each views your agency will help in understanding the advantages and disadvantages regarding divestiture opportunities.

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rating, he noted. Having the coverage also establishes that funds are available for the payment of losses and facilitates the closing of transactions on property that is environmentally impaired, he said.

One of the newer solutions Mr. Lavoie described for managing environmental risk in M&As is "environmental liability cleansing." This involves spinning off environmental liabilities into a special purpose vehicle "and then wrapping an environmental insurance program around that," he said.

David T. Freeman, of counsel to the New York law firm Paul, Hastings, Janofsky & Walker, stressed the importance of "very thorough" due diligence by a buyer or the financier in a merger or acquisition.

The panelists suggested that good due diligence helps the acquiring company to construct a more accurate risk profile of the target company and to uncover hidden liabilities such as uninsured or underinsured risk exposures, insolvent insurers or coverage gaps.

Mr. Freeman outlined basic steps to effective due diligence and risk allocation in an M&A transaction, including:

- Start early by reviewing existing data about the site such as permits, past or present enforcement actions and public records, inspecting the site, and testing the soil and/or groundwater.
- Begin with the end in mind by developing a strategy for addressing and resolving environmental risks at an early stage of the negotiations. This would include defining who pays for cleanup and who controls the cleanup decision-making process, Mr. Freeman said.
- Understand the concerns of environmental regulators.
- Consider all possible solutions to save a deal, such as reducing the purchase price, cleanup cost-sharing, third-party acceptance of specific site cleanup responsibility and the buyer's offer of representations, warranties or indemnities.

As noted by Sengal M.G. Selassie, director of New York-based SG Capital Partners, LLC, who offered a "private equity perspective," the buyer in a deal has enough risks and does not need surprise environmental risks as well.

"You can sleep better at night knowing that [the environmental risks] are being taken care of" through insurance and other means, he said.

Ohio Environmental Ruling Calle

By **E.E. Mazler**

A recent ruling by the Ohio Supreme Court in favor of an insured under an environmental insurance policy is "grim for insurers," an insurance trade group contends.

In a 4-3 decision, the Court held in late June in *Goodyear Tire & Rubber Co. v. Aetna Casualty & Surety Co.* that an insured with multiple policies can pick and choose which policy will cover the cleanup costs when pollutants seep from a site into nearby groundwater.

While the decision in the *Goodyear* case technically applies solely to Ohio, Patrick Watts, vice president of the Alliance of American Insurers, Downers Grove, Ill., cautioned that insurers may not be immune from the implications of the case in other states.

In fact, Mr. Watts cautioned that a party in another jurisdiction might argue that the *Goodyear* line of reasoning should be followed, particularly where there is no precedent in that jurisdiction.

While the *Goodyear* case originally involved pollution cleanup at 22 sites when Goodyear sued in 1993, the issues before the Supreme Court involved only a site in New Castle, Del., and a site in Lansing, Mich.

The Ohio Supreme Court held that:

- When a continuous occurrence of pollution triggers claims under multiple primary policies, the insured is entitled to seek coverage from any single policy of its choice that covers "all sums" incurred as damages "during the policy period." This is subject to the policy's limit of coverage.
- A pollution exclusion clause that bars coverage for the expected or intended emission or escape of contaminants is triggered when the policyholder expects or intends that the contaminants migrate from the location where they were first deposited.
- When correspondence and other documents from governmental agencies fail to spell out to a policyholder that it may be responsible for cleanup costs, and the policyholder did not admit liability for those costs, it is improper to bypass the fact-finder (judge or jury) on the question of whether the policyholder gave timely notice to its insurers about an occurrence or a claim.

The parties agreed that there was continuous pollution over multiple policy periods giving rise to claims to which the applied. But they dis proper method for c across the triggered po

The Supreme Cour rata approach advocate As found by the c approach, each insure "only a portion of a cl duration of the occurre icy period.

The court instead fo present in each of the p the respective insure behalf of the insured emphasis) which th become legally obligat ages" for property dam occurrence.

The court found n policies that reduced a ty if an injury occurr during a given policy the court said that the of the "all sums" prov damages resulting fr occurrence.

The Court went on t site, Goodyear should from the "pool of trigg cies" a single primary p to make a claim. If th cover the entire claim. then pursue coverage fr or excess policies.

The Supreme Cou Goodyear "expected c from each policy tha Additionally, the cour that the "all sums" ap economy for the insur mitting insurers to s from other responsib possible.

Since Goodyear mi excess insurance cover Court reversed the j Court of Appeals that h ed verdicts for the exce

(A directed verdic entered in favor of a judge, usually after the sented its case, based o a matter of law, no rea decide in the plaintiff's

"The excess insu included in the procee rights and obligations in the event that their