

Summer 2004

## Environmental Insurance and M&A

The increase in M&A transactions towards the end of 2003 and the first quarter of 2004 appears to herald the long-awaited recovery from the market's three-year stagnation. This global revival has been dominated by US deal activity with an emphasis on larger transactions<sup>1</sup>.

The private equity sector also appears to be well on the road to a comeback, achieving over 40 percent global investment growth and almost 70 percent growth in North American investment during 2003<sup>2</sup>. The pressure to deploy dedicated funds along with improving exit routes and the increase in M&A activity suggests a surge in private equity-driven transactions.

Gains in M&A market momentum across multiple industrial sectors are producing a major increase in environmental insurance market activity as parties seek solutions to pollution-related deal impediments.

Potential pollution exposures can impact M&A activity today to a degree unheard of even a few years ago. Because such exposures are the subject of increasingly stringent financial disclosure requirements<sup>3</sup>, and are top agenda items for shareholders, lenders and acquirers, these risks – or even the appearance of such risks – can erode enterprise values, threaten transactions or act as a barrier to otherwise attractive projects. (See "Insuring a Good Deal," *Willis Environmental Risk Newsletter*, Winter 2004). Demonstrating the ability to manage these risks, especially long-term pollution liabilities, can have a significant bearing on the economics and overall viability of a transaction.

<sup>1</sup>Thomson Financial

<sup>2</sup>*Global Private Equity Report - 3i* and PricewaterhouseCoopers

<sup>3</sup>"Environmental Issues and Internal Controls," Carla Marino Schwarz - *Willis Environmental Risk Newsletter*, Fall 2003

## Weakness of Traditional Approaches

The uncertainty regarding the magnitude and consequences of environmental risks has made investors and lenders very cautious. This caution is illustrated in a variety of approaches used to mitigate



Approach	Key Disadvantages
Price Discounting	Risk estimates can vary widely and reliable third-party cost verification is often unavailable. One-off settlement typically leads to overcautious compromise which may still fail to satisfy cash sensitive acquirers.
Buyer/Seller Indemnification	Difficult to negotiate. Dependent on the future financial viability of indemnifier.
Escrow and Hold-Back Provisions	Difficult to structure and can require complex ongoing administration. Can reduce transaction value to one or both parties. Prevents immediate access to full sale proceeds.

the environmental risks posed by various M&A transactions. These traditional approaches each possess fundamental inefficiencies and disadvantages.

## Benefits of Environmental Insurance

An increasingly attractive alternative is to transfer these risks into the insurance market. For a single, fixed premium, environmental insurance can be used to cap the cost of known cleanup obligations and protect against the risk of unexpected future losses – providing cost certainty to all parties.

Environmental insurance can be used to:

- Eliminate or mitigate potential transaction barriers
- Protect parties from long-term environmental liabilities
- Focus negotiations on core businesses and assets
- Replace or strengthen warranties and indemnifications
- Eliminate reliance on future financial viability of other parties

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- Allow clean exits and access to full sale proceeds for sellers
- Reduce perceived transaction risk to lenders

**For a single, fixed premium, environmental insurance can be used to cap the cost of known cleanup obligations and protect against the risk of future losses.**

Insurance allows deadlocked deals to be unlocked. Securely rated insurance companies can be used to underpin warranties and indemnities from counterparties with weak balance sheets. An increasing number of organizations are using these products to improve the value of their transactions.

### Key Types of Coverage

The design of an appropriate environmental insurance program ultimately depends on a number of factors, including the nature of the environmental exposure and the risk appetites of the transaction participants. Our M&A solutions often employ offerings from the following product categories.

#### Pollution Liability Insurance

Pollution liability insurance protects against losses from unknown sources of pollution liability. The unknown sources may be either existing contamination that has not yet been discovered or contamination resulting from releases in the future.

Coverage applies to:

- Third-party claims for damage or bodily injury
- Onsite and offsite mandated cleanup costs
- Associated expenses for legal defense and investigation

#### Remediation Cost Cap

Cost cap insurance is designed to minimize cost uncertainties associated with known cleanup obligations. This insurance provides the funds for unanticipated cost overruns that might arise from a variety of factors including discovery of additional contamination, underestimation of project costs or changes in regulatory requirements.

#### Blended Finite Programs

These programs provide a way for parties to convert the financial uncertainties associated with a known contamination liability to a quantified cost item. They combine the efficient pre-funding of planned cleanup expenses with conventional insurance to cover the risks associated with unplanned cost overruns and unknown contamination.

### Liability Buyout

An increasingly attractive option for addressing environmental liabilities in an M&A transaction is to involve a third party who will assume cleanup liabilities for a single fixed cost. A growing market of engineering service providers will accept management of these risks and may, if desired, assume ownership of contaminated assets. This liability transfer is enabled by a structured insurance program providing long-term financial assurance and security. Sellers can thus transfer contaminated assets to buyers without either party retaining or assuming any cleanup obligations.

A recent transaction involving the sale by a multinational corporation of a US industrial operation to a local management team illustrates the value that environmental insurance can deliver.

The seller was interested in a release from the multimillion dollar remediation liabilities associated with the main operational site. While there had been no regulatory involvement at the site, the seller wanted the contamination issues addressed due to concerns over contingent liabilities should the buyer fail.



The purchaser agreed to implement a cleanup of the site in return for an appropriate financial consideration. The two sides were unable however to reach agreement on an appropriate cost estimate for full site remediation.

The parties eventually agreed to transfer the responsibility and liability for the cleanup exercise and the achievement of regulatory closure to a remediation company on a guaranteed fixed-price basis. The contract was supported by a fully funded insurance program that provided protection up to twice the value of the estimated liability.