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Environmental risks in M&A transactions

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Environmental insurance enables buyers and sellers to cover risks from contaminated sites. Environmental risks represent a major challenge in M&A transactions in the chemical industry. It is not uncommon for negotiations to fail due to the allocation of such risks, especially those arising from contaminated sites. There are a variety of reasons for this.

Firstly, existing contaminated sites are often not known or have not been sufficiently examined; they often originate from the legal predecessor's time. Secondly, a thorough examination is often not expedient due to approval, notification and decontamination requirements from authorities. Another reason is the uncertainty as to whether and against whom the authorities will take action within the bounds of their discretion (perpetrator(s), owner(s), former owner(s), user(s)). In addition, the costs of any examination and decontamination are difficult to estimate in advance. Finally, the level of economic risk posed by examination, decontamination, business interruption, personal injury and environmental damage, liability to third parties, consultant fees, etc. is also definitely a factor.

Typical negotiated solutions

Depending on the relative power of the parties, common negotiated solutions range from full allocation of the risk to the buyer or a price discount, through to a warranty or indemnity – which may be more or less limited in terms of its extent, duration and amount – issued by the seller. The risk of the obliged party becoming insolvent is covered in individual cases by a bank guarantee or a trust account.
The seller should also consider statutory liability risks. Although the deal team may be unaware of any contaminated sites, a breach of the duty to provide information could still trigger statutory liability to the buyer if knowledge of such sites exists within the organisation or in the seller's books.

Conventional W&I insurance

Warranty and indemnity insurance (W&I policy) is not only a feature of PE deals, but is also increasingly used on a regular basis in transactions with strategic investors. However, as regards the environment, a W&I policy is limited to legislative compliance and the relevant approvals, and thus generally does not cover risks arising from contaminated sites. In individual cases, a

seller's warranty that there are no contaminated sites (apart from those disclosed) can be insured.
A prerequisite for this is a "phase 1" environmental due diligence report without any negative findings. However, as a rule, such a seller's warranty is only insured "according to the seller's knowledge", which means that contaminated sites that are not known to either the seller or any other party are uninsurable.

Special environmental insurance

In contrast, special environmental insurance, which is increasingly offered on the market, can cover unknown and, in some cases, known risks arising from contaminated sites. It is independent of the allocation of environmental risks in the company purchase agreement and usually structured as follows:

- The policyholder is the target company (the buyer in the case of asset deals).
- Unknown and, in some cases, known contaminated sites are insurable; the insurability of known contaminated sites depends on the extent and nature of the contamination as well as on whether specific claims have already been asserted.
- The insurance covers costs and damage incurred by the target company, including the cost of examinations and decontamination, environmental damage, damage incurred by third parties (including personal injury), for which the target company is liable, as well as consultant fees; cover can additionally be extended to include interruption to the policyholder's business as well as fines and penalty payments incurred by the target company.
- However, financial damage suffered by the buyer, in particular due to any recalculation of the purchase price, is not covered.
- The duration of the policy is generally 10 years from when the transaction is closed.
- The policy can optionally be extended to include new environmental contamination that was not caused until after the transaction was closed.

If the environmental risk is discovered due to voluntary examinations, business expansion or underground building work, the cover does not apply. This is in line with typical restrictions on use for the purchaser in the company purchase agreement (covenants). The same applies if the business is shut down.

A prerequisite for insurability is usually a "phase 1" environmental due diligence report. A "phase 2" report is required in the case of a significant history of industrial usage. The level of the premium will vary widely depending on the amount of cover

and the deductible, as well as the risk profile and the quality of information. It is generally between 0.5% and 3% of the amount of cover. The deductible is typically between 0.5% and 2.5% of the amount of cover.

The extent of the examinations required and the financial parameters can be significantly optimised by advice from, and negotiations with, the insurers.

Conclusion

Sellers in M&A transactions are not willing to issue warranties or indemnities for environmental risks, or are only willing to do so to a limited extent. Both sides may deem a discount on the purchase price to be inadequate or unacceptable. One possible solution is environmental insurance that provides full or partial legal and financial cover for risks arising from contaminated sites. It can be taken out either on its own or in addition to a conventional warranty and indemnity policy.

The highly specific circumstances of each case (risk profile, information base) mean that individual negotiations with the insurers and the careful interlinking of the policy with the provisions in the purchase agreement are particularly important.

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