

MANAGING ENVIRONMENTAL RISKS IN M&A: REPRESENTATIONS AND WARRANTIES INSURANCE AND POLLUTION LEGAL LIABILITY



A common concern in many mergers and acquisitions (M&A) is potential exposure to environmental risks, which can adversely impact an M&A transaction at multiple points, including:

- Negotiation of the purchase and sale agreement terms and deal closure.
- Post-transaction management and financial performance.
- A financially positive exit strategy in the future.

Controlling risks during M&A transactions has been facilitated by the evolution of insurance solutions tailored to M&A needs. For environmental risks, these insurance solutions include pollution legal liability (PLL) insurance and representations and warranties (reps and warranties) insurance.

For decades, PLL insurance has been the traditional solution for managing M&A-related environmental risks. However, more recently, reps and warranties insurance has evolved to cover some transactional environmental issues. Implementing a sound environmental risk management program requires an

understanding of both these solutions and how to dovetail coverage to maximize protection.

REPRESENTATIONS AND WARRANTIES INSURANCE

Specific representations and warranties regarding environmental matters are made in the purchase and sale agreement. The parties' due diligence and disclosure exercises may include obtaining Phase I due diligence reports (site assessments) and other environmental documentation that describes known conditions, or may include specific disclosures of environmental issues.

Reps and warranties insurance covers certain environmental risks under the definitions of "loss" and "breach." For coverage to be triggered, there must be a loss associated with a breach of an

Who it's for

- Companies involved in mergers and acquisitions.
- Private equity firms and other investors.
- Law firm advisors.

What you get

- A risk management solution that can appropriately manage specific risks and transactions.
- Maximum applicability of reps and warranties insurance.
- Appropriate use of traditional environmental insurance.

underlying representation and warranty. From an environmental perspective, a breach would be the discovery of a pollution condition that was previously unknown to the buyer or seller, depending on the type of policy acquired. The insurer then would typically pay for losses associated with such unknown pollution conditions.

When using reps and warranties coverage for environmental risks, the following should be taken into account:

- The coverage is expected to pay for the cleanup of unknown pre-existing conditions, including associated permitting.
- New conditions coverage is not provided.
- Consequential losses, such as third-party bodily injury, third-party property damage, business interruption, and natural resource damages may not be covered. Coverage for non-owned disposal sites and divested properties is also not guaranteed.
- Policy terms vary from one to six years.
- Self-insured retentions are typically 1.5% to 2% of the transaction value.
- Limits and self-insured retentions are shared with other reps and warranties-related risks.
- Coverage applies to environmental laws at the time the deal is closed and does not cover changes in laws going forward.

- There is no duty to defend under reps and warranties insurance policies, although defense costs will be paid once a breach has been determined to have occurred.
- High-risk industries such as chemical, petrochemical, and heavy manufacturing are not a target class for environmental coverage under a reps and warranties policy.

POLLUTION LEGAL LIABILITY

Although reps and warranties insurance provides some environmental coverage, PLL is the primary insurance for environmental risks since it is explicit, broad, and defines environmental coverage, such as cleanup (pre-existing and new), third-party bodily injury, property damage, natural resource damages, business interruption, non-owned disposal sites, divested properties, and legal defense with duty to defend. Other PLL coverage benefits include:

- Self-insured retentions that permit earlier risk transfer and carrier payment (\$50,000 to \$250,000 per pollution condition).
- A coverage response that has been validated through the claims and legal process over several decades.
- Policy terms that can be as long as 10 years to facilitate a long-term hold or an exit strategy that allows the policy to be assigned to buyers with sufficient residual term.

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BEST PRACTICES IN USING PLL AND REPS AND WARRANTIES

Several reps and warranties carriers have indicated that they are not looking to replace the broad PLL policy coverage and would prefer that it sit in excess of an existing environmental policy as representations and warranties insurance is generally viewed as an excess policy for environmental matters.

PLL and reps and warranties insurance should be used together to cover high-risk industries where no reps and warranties insurance is available for environmental matters. However, PLL is best applied as primary coverage where there is a need to provide:

- Explicit, broad coverage around operating sites, non-owned disposal sites, and divested properties.
- Dedicated limits.
- Longer policy terms when it is necessary to cover operations and exit strategy horizons longer than one to three years from policy inception.
- Coverage for new conditions or to manage risk associated with a change in laws.

MARSH CONTACTS

JAMES VETTER
Marsh’s Global Environmental Practice
+1 215 262 3736
james.vetter@marsh.com

CRAIG WARNKE
Marsh’s Transactional Risk Practice
+1 212 345 3332
craig.warnke@marsh.com

CRAIG SCHIOPPO
Marsh’s Transactional Risk Practice
+1 212 345 6492
craig.schioppo@marsh.com