

How to Address Environmental Risk



Summary:

Representations and warranties insurance has emerged as a common tool in the current M&A market.

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Mergers and acquisitions (M&A) insurance solutions are effective tools to facilitate the closing of mergers and acquisitions and finance transactions when parties require additional comfort on a variety of issues. Proven strategies to achieve certainty of closing, these solutions are used by buyers and sellers to bolster both the decision-making process and approach to risk allocation at times when traditional legal opinions/expert advice, indemnity, escrow or sales price reductions do not provide adequate financial comfort or could impair the economics of the deal. Representations and warranties insurance, specifically, has emerged as a common tool in the current M&A market – serving as a means for sellers to effectuate a clean exit and for buyers to ensure they have a viable source of recovery if the business ultimately is not what it was represented to be. Typical R&W coverage generally extends to most, if not all, of the representations and warranties provided by the seller or target company in the purchase agreement, including fundamental representations such as title and authority as well as the full suite of business representations, including financial statements, tax, intellectual property and undisclosed liabilities. Of course, the scope of coverage varies deal to deal depending on the operations of the target company and industry risk profile, as well as the depth of the buyer's due diligence process. Carve-outs to coverage are often limited and, when proposed by the insurer, are narrowly tailored to the specific known issue causing concern. One area that can be challenging to insure is environmental risk. Insurers' ability to cover an environmental representation within the R&W policy is case-specific and depends on not only the environmental footprint of the target but also what issues are uncovered during diligence. Deals involving target companies with a relatively light environmental footprint or a positive claims history are often successful in achieving coverage of environmental representations – those that fall outside this category may confront exclusions for specific environmental conditions or, in the most severe case, an exclusion of the environmental matters representation itself. Subject to underwriting, coverage for “paper” environmental risk such as licenses and permits can often be preserved. In any circumstance, however, R&W policies are not designed to provide coverage for known contamination, active remediation or toxic tort allegations. For dealmakers grappling with limitations to coverage of environmental matters in the R&W policy, all is not lost -- acquisitions of target companies without a clean bill of



environmental health or involved in a risky class of business are not left without options. Stand-alone environmental insurance can be an effective complement to an R&W policy to help plug the gap in coverage around the environmental representations. Depending on the nature of the transaction and the complexity of the target company's site(s) and operations, a properly designed environmental site liability policy, which is also known as pollution legal liability, can complete the R&W placement. This can be accomplished by providing essential first- and third-party coverages including defense costs addressing known and unknown environmental conditions, with certain restrictions, with or without an environmental representation contained in the underlying purchase agreement. As a complement to the R&W policy, a customized environmental policy may also be able to replace or supplement an escrow or indemnity, becoming a value-accretive tool for future deals involving the insured site/operation by the careful addition of policy assignment provisions. R&W policies similarly afford assignment of rights to a future purchaser of the stock or substantially all of the assets of the target company, providing an attractive value-add for future divestment. **See also:** [The Environment for M&A in Insurance](#) Environmental site liability policies do not rely on establishing a breach of a representation and its subsequent damages. They are designed with a relatively low retention, as compared with an R&W policy, and are responsive to changing environmental regulations that can give rise to a loss. Written on a "claims made" basis for policy terms up to 10 years, environmental site liability policies can provide first-party clean-up and third-party protection for clean-up, bodily injury or property damage claims for known and unknown environmental conditions. This product has the broadest application of any single environmental product line due to its flexibility of wording and risk specific underwriting. From an operational standpoint, the environmental policy can be structured to either cover an entire corporation's operations or a single site. Extensions of coverage for ancillary current or historic operations can also be covered including divested locations, waste disposal, transportation and business interruption. Coverage offered may be tailored to all historic operations pre-closing and extended to continuing operations for the target company post-closing. Additionally, the environmental site liability policy provisions are flexible enough to be used in lieu of an indemnity or to support indemnity requirements of a purchase and sale agreement by responding to an indemnified party for payment under the terms of the purchase and sale agreement if the indemnitor fails, or is unable, to honor its indemnity. This coverage extension is known as an "excess of indemnity" and is carefully underwritten with counsel and a comprehensive review of the purchase agreement. The placement of comprehensive environmental insurance may also help avoid carve-backs to coverage under the R&W policy by providing insurers comfort that the R&W policy is not the first line of recourse on environmental issues. In those instances, the R&W policy specifically sits excess of the underlying environmental policy, responding only after such policy limits are exhausted (or loss incurred equivalent to the underlying limits if the environmental insurer is unable to satisfy the claim). Careful drafting of the "Other Insurance" provision in the R&W policy is needed to ensure the smooth function of such a structure. Consider a buyer looking to acquire a nine-facility target engaged in wood treatment operations since the 1960s. Two facilities are currently the subject of an indemnity included in a 1980s purchase agreement with remediation continuing at those locations. The buyer has negotiated for the indemnity obligation to continue through the current transaction, but there are seven sites without any such indemnity. Although the R&W underwriter recognizes the environmental representation and associated indemnity with respect to two of the sites, the



absence of protection on the remaining sites and long history of operations creates concern and thus the need for environmental issues to be insured separately. The environmental broker designs a tailored solution including two policies to provide a comprehensive risk management solution: *Policy 1*: Properties that are the subject of the indemnity receive a policy dedicated to the scope of coverage under the indemnity; the coverage matches the indemnity obligations and applies on an excess basis; the policy is triggered by failure of the indemnitor to perform on their obligation, in excess of the policy self-insured retention (SIR). *Policy 2*: Provides coverage for new conditions and unknown pre-existing pollution conditions at all nine locations; known conditions at sites without the indemnity are excluded for remediation costs Both policies carry a 10-year policy term, with exception of the new conditions coverage policy that is limited to three years. Policy 1 responds if the indemnifying party is unable to perform. The seller was able to limit the scope of the indemnity solely to known and quantified clean-up obligations. Any additional indemnity for unknown conditions or tort liability associated with known or unknown issues was not required because the insurance program provides that coverage. Both Policy 1 and 2 also contained assignment provisions that are beneficial in the event of a future sale. In another instance, a transaction stalls when the R&W underwriter declines to insure the environmental representations of a large global equipment manufacturer because due diligence demonstrates that the target locations likely have significant environmental impacts due to long-time solvent use. The environmental insurance broker is called in to design a solution: *Policy 1*: Provides coverage for all pre-existing conditions, known and unknown, where the most challenging locations assume a higher self-insured retention and the policy restricts coverage for remediation by applying a capital improvement and voluntary site investigation exclusion coupled with a third-party trigger for any remediation claims. A 10-year term applies, and the other insurance provisions are modified to primary coverage; most importantly, the policy does not specifically exclude any constituents. *Policy 2*: Is written on a three-year term and provides coverage for new conditions from date of sale forward for the continuing operations. Coverage is restricted in a similar matter to Policy 1. The environmental program structure described above was quite beneficial to the seller because it did not contain any constituent exclusion. This solution also allowed the R&W underwriter to provide coverage for the seller's environmental representations on an excess basis. As these examples suggest, the current environmental marketplace is competitive, resulting in favorable coverage terms, conditions and premium for many transactional risks. Limits of up to \$50 million are potentially available from a single carrier, and total limits of \$500 million are potentially available for layered programs involving multiple carriers. Significant capacity is similarly potentially available for R&W insurance with limits available of up to \$50 million-plus from any one carrier and close to \$1 billion on an aggregate basis per deal. The significant increase in demand and use of R&W policies over the past few years has also translated into a very competitive marketplace, resulting in decreased pricing and broadening coverage and appetite for challenging deals. **See also:** [*Developing A Safe Work Environment Through Safety Committees*](#) The strategic use of R&W insurance coupled with an environmental policy can be indispensable in helping buyers and sellers move a transaction forward to a smooth and successful close. Dealmakers and their advisers should carefully consider the environmental risks posed by the operations of the target company early in the deal to determine how such risks will be apportioned between the parties and if insurance, whether a R&W policy, environmental policy or both, provides an



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opportunity to secure protection against such risks while maximizing the economics of the transaction. *All descriptions, summaries or highlights of coverage are for general informational purposes only and do not amend, alter or modify the actual terms or conditions of any insurance policy. Coverage is governed only by the terms and conditions of the relevant policy.*



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