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Seven Environmental "Do's" and "Don'ts" for Private Equity Investors

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Private equity ("PE") investment opportunities abound in many commercial sectors, including those with a history of more intensive chemical use and, hence, greater risk of environmental liability. Over the past two decades, PE investors, and lenders to PE investors, have become much more sanguine about environmental liability risk. As they gear up to participate in an active market, the following "do's" and "don'ts" will help PE investors avoid unnecessary environmental liability risk.

1. When Acquiring Equity, Do Proper Diligence into Legacy Environmental Liabilities

When a PE firm buys a portfolio company from another PE firm, the acquisition is almost always structured as an equity purchase (e.g., the purchase of the target's stock or LLC member interests). With that structure, and without indemnities, equity purchasers succeed to all the target's legacy environmental liabilities.

In these situations, it is not a challenge for equity purchasers to perform thorough environmental diligence on the target's current operations. They can secure Phase I environmental site assessments and compliance reviews of the target's current facilities. That diligence is useful in identifying environmental conditions associated with current operations. It will not, however, reveal all the target's potential legacy liability.

Two types of legacy environmental liabilities are frequently a concern: (1) liability associated with environmental conditions at the locations at which the target formerly operated, but at which it does not operate currently, and (2) liability associated with off-site disposal locations that those former operating locations used.

Targets should be able to identify former facilities where they operated in recent decades. Environmental consultants can run those locations through online databases to assure the locations are not subject to contamination claims. Targets should also represent in the acquisition agreement that they have received no claims with respect to their former operating locations or disposal sites.

2. Do Not Take Actions Post-Asset-Acquisition That Defeat the Defense to Successor Liability

If a PE firm is fortunate enough to be able to structure its acquisition as an asset purchase, it should be careful not to take steps post-acquisition that defeat its entitlement to the asset purchaser defense to successor liability.

Where buying a business unit or division of a public company, a PE firm will likely be able to structure the deal as an asset purchase. With an asset purchase, the buyer does not succeed to all the legacy liabilities of the business it is buying. So the buyer does not succeed to, for example, liability for the off-site disposal locations to which the acquired business' facilities formerly sent their waste. Nor does the buyer succeed to liability for environmental conditions at former operating locations of the acquired business.

There are a few ways buyers can undermine the asset purchase defense to successor liability during the transaction. Language in the acquisition agreement can either expressly or impliedly assume pre-existing environmental liability. Also, where there is some overlap of equity holders before and after the transaction, there is a risk of the transaction's being considered a de facto merger or "mere continuation."

Even where the acquisition agreement is drafted to avoid an express or implied assumption and there is no overlap of any equity holders, in some jurisdictions, actions buyers take after the acquisition is completed can undo the asset purchase defense to successor liability. Some courts have held that where the resulting business holds itself out to the public as being the continuation of the predecessor business, it succeeds to the liabilities of the predecessor business. Things courts consider include retention of employees, including supervisory personnel, and making and selling the same products made at the same facility.

3. Do Take Particular Care, in the Acquisition Agreement, in Describing Included and Excluded Assets and Liabilities

In an instance in which a PE firm is buying a business unit or division of a public company, special care may be needed in describing precisely the assets and liabilities that the PE firm is—and, perhaps more importantly, is not—acquiring. The seller may not have organized itself in exactly the same manner in which it was organized at the point of sale. In the past, it may have had operations associated with the unit or division the PE firm is going to buy that are not parts of the current acquisition. Excluding what is not part of the deal can become very important.

There are a couple examples I like to use when I teach this topic to law students. One involves the division of a former diversified conglomerate into two businesses: one focused on technology and the other, natural resources. A couple years before this split into two businesses, the conglomerate sold a single refinery located on the Houston ship channel.

The conglomerate split itself into two businesses using, in part, the following language: "the assets transferred under this agreement are subject to all liabilities related to/or arising out of or in connection with such assets, and grantee does hereby undertake, assume, and agree to pay, perform and discharge as they mature, accrue, and/or become payable, all such liabilities."

Several years later, a third party tried to argue that the natural resource business created as a result of the division of the conglomerate into two separate businesses succeeded to liability arising from the

Houston ship channel refinery. The contention was that the refinery had been part of the conglomerate's former natural resource business, so the liabilities of the Houston refinery went along with the assets transferred to the new natural resource business.

The court was unpersuaded, finding that the liability assumption was only effective as to the assets transferred pursuant to instant transfer agreement and not the refinery transferred two years earlier. To have the alleged effect, the language would have had to say something like, "related to or arising out of or in connection with the assets related to the natural resource business, *whether owned now or in the past*."

4. Do Share Your Counsel's and Your Consultant's Environmental Diligence Reports with Your Lender

By sharing its counsel's and consultant's diligence reports with environmental counsel for its lender, PE firms will greatly increase the odds that their lender will perceive the environmental liability risks of the purchase in much the same way as the PE firm does.

Environmental counsel for lenders frequently learns of its bank client's interest in providing acquisition financing to a PE sponsor with little time to pore over the environmental disclosures posted to a virtual data room. PE sponsor's counsel and consultants have generally had much more time to think about the environmental liability risks of the target's business. As a result, they are in a much better position to prioritize risks that might be material to the acquisition. Perhaps even more importantly, they have had more time to consider why certain environmental conditions do not pose a material risk.

Banks know that to have access to PE sponsor's counsel's and consultant's findings, they will need to sign non-reliance letters. They generally will.

Disclosure of counsel's and consultant's diligence reports will allow lender's environmental counsel to get up to speed quickly. If he or she needs to, lender's counsel can refer to a particular disclosure in the virtual data room to confirm the PE sponsor's advisors' conclusions.

5. Do Have Your Environmental Consultant Quantify Identified Environmental Liability Risks

Successful environmental transactional counsel know that their clients—whether PE sponsors or banks' lending to PE sponsors—like to have environmental liability risks quantified. The statutory or common law origins of the risks—as fascinating as they may be to the devoted environmental lawyer—hold little sway with deal makers.

Lenders' environmental counsel will generally not have access to their own technical consultants to provide such quantification. Without the benefit of PE sponsors' consultants cost estimates, lenders' counsel, therefore, will not be able to quantify risk for their bank clients. While they may be able to speculate that an identified risk is unlikely to be material, they will not be able to put a dollar estimate to it. It is simply not something lawyers generally do.

If a PE firm has had its environmental consultant provide a dollar estimate for addressing an environmental condition, it should share that estimate with lender's environmental counsel. One can imagine how quickly a lending officer will move on from an environmental condition if counsel can report that the sponsor engaged a credible consulting firm, which investigated thoroughly, provided conservative estimates of necessary corrective measures, and, all totaled, those estimates are unlikely to be material to the financing.

6. Do Not Ignore Corporate Formalities so as to Become Liable — Beyond Amount of Investment — for Acquisition Subsidiary's Acts or Omissions

It is axiomatic that PE firms will create subsidiaries through which to consummate their acquisitions. I often wonder, however, if they continue to maintain corporate formalities once they have closed the deal.

Several years ago, I recall having this conversation with the director of a rapidly growing PE fund that was investing hundreds of millions of dollars in an industry rife with the potential for environmental liability. I was gently kidding the director about the risks he was creating for himself by becoming directly involved in the portfolio company's day-to-day operations. At the time, the PE fund was part of a then very well-regarded global financial services firm. The director chided me that his investors placed their money in the PE fund because of the fund's corporate parentage. That may well have been true, but it did not persuade me that he should not have exercised more caution.

The U.S. Supreme Court has established a pro-business test for determining whether a parent can be directly liable for the acts or omissions of its subsidiary. The Court said the parent must, essentially, operate its subsidiary's facility and must get involved in the pollution-creating conduct. My concern about my client PE fund director was that he was risking doing just that.

In addition to being directly liable for their subsidiaries, parents can also be derivatively liable by failing to follow corporate formalities. That is, they can have their "corporate veil" pierced if they do not adhere to legal requirements that preserve the limited liability of the corporate form. Those requirements include separate boards of directors, acting through the board, meetings and minutes of board meetings, adequate capitalization, not commingling funds, arm's length intercompany transactions, etc. These considerations are no different with respect to a subsidiary's environmental liabilities than they are with respect to any other subsidiary liability (e.g., pension liability).

7. Do Not Ignore Facility Compliance Findings from Acquisition Diligence

In addition to Phase I environmental site assessments, it has become commonplace for PE firms to post limited compliance reviews of the facilities operated by the portfolio company they intend to sell. Unlike Phase I's, which focus exclusively on releases into the environment ("spills"), a compliance review examines a facility's compliance with the rules that govern, for example, its air emissions or wastewater discharge. If the seller does not post limited compliance reviews, the prospective buyer may insist on some form of facility compliance assessment.

Compliance reviews may be particularly useful where the portfolio company lacks a headquarters environmental compliance function, perhaps because its operations do not require that degree of environmental oversight. Without that central oversight, different personnel at the portfolio company's different facilities may approach environmental regulatory compliance in inconsistent ways.

A trap a PE firm can fall into is to fail to follow up on the facility noncompliance findings in its acquisition diligence. The PE firm can reach the correct conclusion that environmental regulatory discrepancies identified during acquisition diligence are immaterial to the financial advisability of the acquisition. Failure to have storm water permits, spill prevention control and countermeasure plans, or to have filed chemical use information with local emergency responders are not the types of concerns that may be central to the business or likely to risk substantial penalties if detected by a government agency. As a result, after it closes the deal, the PE firm forgets about the discrepancies and fails to look ahead to its exit.

Three or five years after closing, when the PE fund plans to sell the business, the pre-acquisition diligence reports may be the only comprehensive environmental reviews of the portfolio company's facilities. As a result, the fund may find itself compelled to disclose those reviews. It hardly makes a strong impression if the fund cannot also disclose documents establishing that all the discrepancies identified at the time of acquisition have since been addressed. These may indeed be minor, and clearly immaterial, matters. That they have been allowed to persist many years after the acquisition, however, hardly creates the impression of a well-run business.

Because the seven environmental "do's" and "don't's" listed here are not "rocket science," it is surprising how often they can be overlooked in the rush to close a deal or afterward. They are overlooked at a fund's peril.

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