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DUE DILIGENCE

Environmental issues in M&A deals

BY CLAIRE SPENCER

As the global community grows more sensitive towards environmental issues, these same issues are appearing more frequently in M&A transactions. A company's carbon footprint, emissions, and general environmental impact are now under heavy scrutiny, and acquirers need to take this into account. The environment has become one of the top priorities of many political agendas, and ignoring that could be detrimental to the reputation, and therefore value, of a company and its acquisitions. Further, there could be other liabilities involved, and so it is prudent to identify and analyse the possibilities during the due diligence phase. The results of environmental due diligence (EDD), which may not seem earth shattering at the time of closing, could make or break a deal in the years ahead, particularly if the costs of complying with environmental regulations prove to be too high.

Major political and regulatory changes have influenced EDD in recent years, driven by the heightening issue of climate change. These changes have been different on either side of the Atlantic. "The US is not a signatory to the Kyoto Protocol, therefore US regulation of greenhouse gas emissions has lagged behind that of the European Union," says William F Stewart, attorney and head of the climate change & global warming practice area at Cozen O'Connor. "However, in the US there have been many state initiatives and several regional initiatives involving multiple states, to curb greenhouse gases emitted by certain targeted industries. Moreover, by almost all accounts, the US is on the verge of adopting either a carbon tax or more likely a cap and trade system, to limit GHG emissions." Although some states are active in environmental regulation, the decision taken by the US administration not to ratify the Kyoto Protocol means that authorities are not compelled to react by implementing particular laws.

The EU is widely considered to be the trailblazer in the introduction of innovative environmental laws, such as those relating to climate change. According to Elizabeth Shepherd, a partner in the clean energy and sustainability group at Eversheds LLP, the major legal instruments to date include the EU Emissions Trading Directive, the Energy Performance of Buildings Directive, the UK's Climate Change Levy and associated CCL Agreements, and the proposed carbon reductions commitment, another emissions trading scheme starting in 2010. "This flurry of regulation has been fuelled by the political commitments to the issue, such as the UK government's goal in the 2003 Energy White Paper to reduce CO2 emissions by 60 percent by 2050 (which may be increased to 80 percent), and the Climate Change Bill," she says. Climate change laws, and numerous others pertaining to the production and disposal of hazardous chemical substances, have had a substantial impact on the evaluation of a target company based in the EU.

To be effective, EDD practices must keep up with fast paced regulatory changes. Historically, it was required for the sole purpose of assessing the contamination and compliance issues faced at each of a target's individual sites. But recently, although the issues have usually remained site related, EDD has been widened to include an assessment of the company's overarching response to regulations. For example, with regard to the EU Emissions Trading Scheme, the forthcoming carbon reduction commitment and the requirement for energy performance certificates for buildings, energy consumption and efficiency data is increasingly being requested and assessed as part of EDD. "EDD will more and more need to be about assessing how a target has responded to current or forthcoming legislation that will influence its supply chain and operational expenditure," points out Tim Clare, a technical director at WSP Environment & Energy. "Furthermore, the EU's REACH Directive will soon potentially eliminate from the European market certain hazardous chemicals, removing a product from some and raw materials from others. Waste legislation will increasingly be about ensuring producers take responsibility for their products at the end of their lifecycles, resulting in manufacturers having to set up or contribute to take-back recycling schemes. He adds that climate change will increasingly result in legislation that requires products to be more energy efficient, which includes the

use of renewable energies in the long term.

On the whole, most acquirers have accepted that EDD should feature in their target investigations. "EDD has been a key part of mainstream corporate due diligence for some time now," says Ms Shepherd. "Acquirers and their funders typically demand key environmental information and often seek to carry out a Phase I Environmental Assessment. The impact of some of the emerging areas in EDD is to extend what may have been seen as the core 'contaminated land' type issues to cover compliance with the new regulations which have been and are being imposed in response to the challenge of sustainability, for example, the WEEE Directive, the ROHS Directive, and Energy Performance of Buildings Certificates." But EDD is not part of every deal – in some cases it is given less weight or deemed to be irrelevant. This is dependant on the nature of the business and the needs of the parties involved, and not all of them weigh EDD with the same value. Nevertheless, in more transactions, executives realise that the environmental risks they face should not be overlooked.

EDD has evolved beyond an assessment of regulatory compliance and potential liabilities to include decisions made at board level. Vetting the target's management team on its attitude and responsiveness to environmental risks can provide important insights, as Mr Clare explains. "At the simplest level, questioning whether a target's management team has considered sustainability issues and in particular whether climate change and the other principal environmental challenges present it with both risks and opportunities, will say much about their level of forward thinking and planning. Beyond that, there are real risks and opportunities that companies need to face associated with legislation and changing resource costs and markets which will have fundamental consequences for business and these need to be considered in assessing the robustness of a target's business plan," he says.

Environmental issues may have a huge impact on the way the combined entity operates in the post deal phase. They can affect how the company is perceived within the community and how it interacts with other companies in the supply chain. "Consumers are becoming more and more familiar with the carbon footprints and renewable energy policies of those corporations whose products and services they purchase. Similarly, companies are increasingly putting lateral pressure on their trading partners, and downward pressure on their suppliers and vendors, to implement green programs and technologies. Failure to consider a target company's ability to prosper in an environment requiring greater use of renewable energy could have potential devastating effects on post deal value – which in turn might lead to a number of directors' and officers' liability issues," warns Mr Stewart. But acquirers can use the results of EDD to build a framework that responds to green concerns, optimises the company's environmental platform and reduces potential liabilities.

In a more immediate sense, these same concerns can consume valuable management resources at a time when they should be fully focused on post deal integration. This can be a real problem if not dealt with effectively. It is necessary to ensure that all the environmental boxes are ticked to guarantee that all areas of the new company are fully compliant with relevant legislation, so that regulatory involvement doesn't arise at an inconvenient time, at the expense of the business. Management need to have the resources available to ensure that business performance does not deteriorate.

Acquirers have responded in several ways, with varying levels of urgency. The least motivated are sticking to basic compliance, but many others are demonstrating a broader environmental awareness. "Over the last two years we have seen an upsurge in demand from senior players within corporate entities seeking general advice on sustainability and climate change," observes Ms Shepherd. "Major players are now seeking information about the energy performance of building regulations, carbon reduction commitment, green lease, carbon labelling, carbon offsetting and their general sustainability strategies. Serious players are also looking at renewable energy initiatives for their new sites, for example, energy from waste plants, and wind turbines." Still, only a minority have been proactive by properly evaluating the risks and opportunities that climate change, both physically and in terms of future legislation, could have on their business. At the moment, these businesses are chiefly rewarded by an enhanced public image, but cost savings and competitive advantage should eventually follow.

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Since environmental and sustainability issues have only made a meaningful impact on the due diligence process within the last decade, the findings do not usually lead companies to abandon a deal completely. "Environmental dealbreakers do arise within smaller transactions, where contamination issues pose too great a risk to a small enterprise – although this is normally more of a contributing factor and often due to EDD's place at the end of the transaction timeline, sometimes acting as the final straw. Some of the new emerging legislative drivers may increase the number of environmental dealbreakers in the future, however," says Mr Clare.

The big question is whether EDD will become a costly box ticking exercise that falls out of favour with acquirers in the long run. Experts do not think so, believing that environmental trends present great risks along with tremendous opportunities, so analysing these in the context of M&A transactions should only become more integral to long term value creation. "It has been projected that a one trillion dollar carbon market will exist in the US ▸▸

by 2020. The scale of such a massive transfer of wealth associated with the establishment, implementation and operation of that market is hard to grasp. Because some target companies will have hidden value, and because others will have hidden risk, it is imperative for any acquirer to carefully analyse how anticipated regulatory changes will impact the target organisation," says Mr Stewart. With projections like this, it seems unlikely that environmental issues will subside, and acting early is likely to dramatically improve the quality of a brand, allowing it to attract business via its green credentials. The onset of more legislation is inevitable, and acquirers are wise to consider the possibilities. All companies should have a sustainability plan in place, which should be updated every time an acquisition is made. A crucial point to note is that the risks and the opportunities of developing an EDD strategy will not just be related to current or foreseeable legislation or litigation from third parties. A business also needs to consider whether climate change will impact the availability and cost of raw materials, threaten property or cause product markets to contract or increase. In some cases it is a two-sided coin; for example, the scarcity of water will drive up costs for water intensive manufacturing processes but develop markets for water saving products and processes.

Many regions have made leaps and bounds in environmental legislation, but it seems that the speed of regulatory change is one of many reasons why corporate players should be thinking about the environment. Many companies have been looking ahead of the game, preparing sustainability plans ahead of legislation that compels them to do so. They also evaluate target companies in the context of these plans when making acquisitions. Environmental considerations are set to form a much larger part of business decisions, and are already far more important now than they were five years ago. Yet many companies have not begun to integrate environmental concerns such as carbon footprints, emissions, and other related elements into their business plans, and if they fail to act promptly, this could be their downfall when the cost of compliance or reputational impact finally catches up with them. ■

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Bill is a member of the Pennsylvania, Philadelphia, Montgomery County, and Camden County Bar Associations. He is a frequent lecturer and contributor to Business Insurance, Best's Insurance, CPCU Journals, Mealey's Bad Faith Reporter and Mealey's Mold Litigation Reporter.

Bill is an arbitrator for the U.S. District Court for the Eastern District of Pennsylvania and for the Philadelphia Court of Common Pleas and the Montgomery Court of Common Pleas.

In 2005, Bill was selected by the Pennsylvania Supreme Court to serve on the state rules committee. Bill serves frequently as a volunteer attorney for the Montgomery County Children's Advocate Project.

Bill earned his bachelor of arts degree at St. Joseph's University in 1987 and his law degree at the University of Notre Dame in 1990, where he graduated cum laude. He was admitted to practice in Pennsylvania and New Jersey in 1990, and has practiced pro hac vice in more than 10 U.S. states and territories. In 2002 he was elected committeeman in Lower Providence Township Pennsylvania.