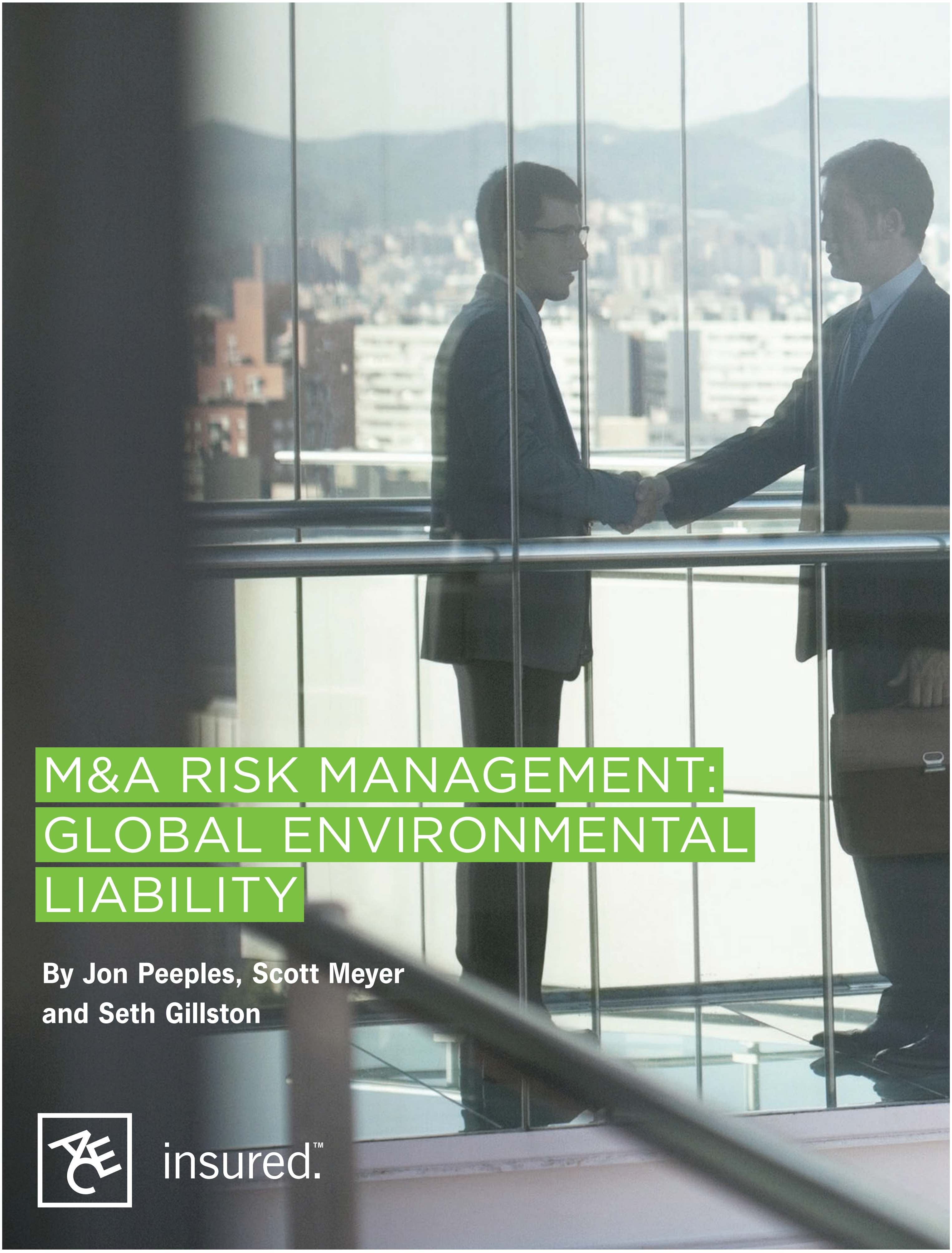

M&A RISK MANAGEMENT: GLOBAL ENVIRONMENTAL LIABILITY

By Jon Peeples, Scott Meyer and Seth Gillston

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Executive Summary

As companies seek strategic merger and acquisition (M&A) growth opportunities across the world, they confront ever-expanding and stricter environmental liability regimes, posing significant import to these organizations and their directors and officers. Liabilities encompass a broad range of perils, including pollution, contamination, mold, hazardous waste, and toxic chemicals in water, air or on land. Identifying exposures and then assembling an effective insurance strategy to transfer environmental liabilities is a vital element of the M&A transaction process.

This report addresses global M&A and environmental liability trends in the context of the exposures they create for directors and officers, and posits ways to effectively manage and transfer these risks. It builds upon a series of other ACE Progress Reports assessing M&A risks.

http://www.acegroup.com/us-en/businesses/mergers-acquisitions-industry.aspx

Global Mergers and Acquisitions

The year 2012 showed an uptick in the growth of M&A and experts believe additional grown is forthcoming. The first quarter news came on top of three successive quarters of substantial growth in global deal values—the highest M&A values experienced in the last five years, according to Mergermarket.

Despite the slowdown in global M&A, deal values in the United States actually increased in the first quarter of 2013 from the same period a year earlier. A remarkable $87.7 billion in transactions occurred in just a nine-day period, according to the study. “Geographically, only the U.S. saw an increase in terms of deal value over that of last year’s first quarter,” the financial information company stated.

The largest deals in the first quarter included Liberty Global’s $21.9 billion bid for Virgin Media, General Electric’s 49.9 percent stake in NBCUniversal to Comcast for $16.7 billion, and Orascom’s sale to Altimo for $6.4 billion.

Private equity was particularly active, with $83.6 billion worth of global buyouts undertaken during the quarter. This is the highest quarterly total since the fourth quarter of 2010, representing 20 percent of M&A activity, Mergermarket noted. Chief among these deals: While Warren Buffett’s $27.4 billion Heinz acquisition.

Several M&A observers remain optimistic that the pace of M&A deals would pick up throughout the remainder of 2013. Baker Tilly, for example, projected that deals involving banks would increase substantially, calling it a “buyer’s market for bank acquisitions.” And 76 percent of respondents to a 2013 survey by KPMG indicated they expect their companies to make at least one acquisition in 2013. Twenty-six percent projected two deals this year, ten percent said they would be making three acquisitions and eight percent indicated four acquisitions.

“Although there is still plenty of uncertainty in the markets, we will likely see M&A activity pick up as the year progresses,” stated Dan Tiemann, Americas Transactions and Restructuring lead for KPMG. “Financing conditions continue to be positive. Many companies are holding large amounts of cash and the U.S. debt markets remain open.”

Certainly, M&A will remain a core part of companies’ strategic growth priorities domestically and abroad. Companies seeking a stronger foothold in emerging markets, particularly within those countries that have liberalized foreign ownership rules, will continue to pursue M&A as the means of entry. As they do, they confront compliance with a patchwork quilt of constantly shifting environmental laws and regulations.

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Environmental Liability Due Diligence

Thousands of environmental regulations are on the books across the world, even in emerging economies. China, for example, has more than 40 laws in place. Most of the laws address well-established environmental policies governing the quality of air, water and land use, while others introduce new areas of liability or are far stricter than previous standards. These evolving legal and regulatory regimes pose compliance risks for multinational companies acquiring and/or divesting enterprises, requiring more in-depth due diligence of a target company's past and present environmental liabilities.

The United States was the first nation to implement strict liability rules for pollution, via the enactments of the Clean Air Act of 1970 and the Clean Water Act in 1972. Other laws include the 1976 Resource Conservation and Recovery Act, and the 1980 Superfund law, implemented in the aftermath of the Love Canal toxic waste incident. More recently, the administration of President Barack Obama has pledged to increase enforcement of existing environmental regulations and promulgate tougher standards.

In 2010, the administration increased funding of the U.S. Environmental Protection Agency (EPA) to $10.3 billion, the highest level of funding for the agency since its creation in 1970, although subsequent budget cuts lowered the budget to $8.97 billion. The EPA now requires mandatory reporting of regulated pollutants for companies in 41 industries, ranging from automobile manufacturers to makers of semiconductors. Penalties for not meeting the new reporting requirements of the Clean Air Act are up to $32,500 per violation, per day, in addition to possible criminal penalties depending on the severity of non-compliance. Fines can be levied for failing to collect data or report greenhouse emissions, or even failing to properly follow the EPA's methodology for collecting data.

In February 2011, the EPA announced that it would begin developing the first-ever national standard for perchlorate, a chemical found in rocket fuel, fireworks, and bleach alleged to pose risk to public water quality. The action reverses an earlier decision made during the administration of President George W. Bush. The EPA also is seeking the establishment of a new drinking water standard, addressing such volatile organic compounds as trichloroethylene, tetrachloroethylene and hexavalent chromium.

The agency is further considering the listing of 30 additional contaminants under the federal Safe Water Drinking Act, including noroviruses and enteroviruses, and such chemicals as testosterone, methyl chloride and methyl bromide. With regard to air quality, President Obama proposed the development of new air quality standards in June 2012 to lower the amount of soot that can be released in the air.

Among recent EPA actions, is a total of $6.8 million in fines levied against fuel transportation companies for failure to comply with a federal mandate requiring the companies to blend an ethanol-derived biofuel into the gasoline and diesel they use. The companies were required to mix 6.6 million gallons of cellulosic biodiesel into the gasoline and diesel in 2011, and 8.65 million gallons in 2012. Problematically, the new biofuel is not yet available on the commercial market.

Environmental regulations in Europe have closely followed developments in the U.S. In 2004, the European Parliament and the Council of Ministers approved the Environmental Liability Directive (ELD), making companies financially liable for cleaning up environmental damage caused by their actions. By 2010, all 27-member European Union (EU) countries had written the directive into their own national laws, and since then some 50 cases have been brought under its principles.

Although the directive establishes a common baseline for the 27 members of the EU, it takes environmental liability in new directions. The law is broad, covering damage to protected species, natural habitats, water and soil. It further addresses a new class of pollutants—genetically-modified organisms released into the environment. While the directive establishes a `polluter pays' standard similar to the Superfund law in the U.S., it does not apply joint and several liability. Companies also are required to prevent and remedy environmental damage that appears imminent. This contrasts with established environmental laws that call for remediation only in the aftermath of the incident.

The directive only applies to damage caused after April 30, 2007, and there is no cap on liability. It does, however, permit two exceptions to financial liability—if the company causing damage acted in accordance with “the conditions of an authorization” provided under national laws, or it operated according to the state of scientific and technical knowledge that existed at the time of the damage.

Finally, the directive does not preclude member countries from having stricter environmental requirements. The United Kingdom, for example, has written into law the Waste Electrical and Electronic Equipment Directive, establishing rules for the collection, recycling and recovery for all types of electrical and electronic devices. In January 2012, a plenary vote of the EU upheld the directive. Once the European Council formally approves the directive, which is expected, member countries will have 18 months to update their national legislation and implement the rules.

Despite the broad sweep of the directive, each member state of the EU also has its own, singular environmental laws. In Germany, for instance, environmental laws govern different industry sectors insofar as air quality, waste management, soil protection and noise pollution, sometimes with different terms and regulatory approaches. And in France, there is no requirement to purchase insurance or other means of financial security against the risk of environmental damage, which differs with the approach in other EU member countries.

For multinational companies with wide-ranging products and services, compliance with the fractured and constantly evolving environmental liability regime in Europe is complicated. Each time that an unexpected natural disaster or pollution accident rears, countries typically enact new regulations to calm public fears. This ceaseless progression takes many companies by surprise. A survey of more than 700 companies in Spain, for instance, indicates a significant lack of awareness of environmental legislation, the risks this poses to the organizations and the insurance protection available to absorb the exposures.

Countries in Asia-Pacific and Latin America have enacted stricter anti-pollution laws, driven in part by a burgeoning middle class insisting on a higher quality of life. A recent poll of Chileans, for instance, indicates that 69 percent believe environmental sustainability is more important than job creation. Recent rules include tougher maritime pollution laws in Australia and New Zealand, punitive environmental information disclosure rules in China, new vehicle emissions standards in Brazil, noise pollution regulations in Singapore, and new plastic waste management regulations in India, among many others.

D&O and EIL Exposures

As multinational companies seek acquisition opportunities in diverse global markets, they confront ever-wider and stricter environmental regulations shifting liability to the purchasing entity. In many countries, the acquiring company may inherit the target company’s pollution exposures (and the exposures of entities the target company previously acquired), going back decades. Assessing the scope of these successor liabilities is made difficult by poor record-keeping practices, and the fact that a company may have caused environmental damage when the action was unregulated in past, and has since been deemed illegal.

Determining post-acquisition environmental liability can challenge the best due diligence—hence the prudence in managing ongoing risk through a multinational insurance program that absorbs the successor liabilities in a materially compliant manner. Among the insurance policies in such a program is Environmental Impairment Liability (EIL) insurance, which absorbs the financial costs associated with cleaning up accidental spills or leaks of pollutants, thereby addressing the coverage voids created by the pollution exclusions in general liability and D&O liability insurance products.

Premises Pollution Liability (PPL) insurance is a valuable adjunct, particularly in circumstances where a target company owned facilities that generated or used hazardous substances. PPL insurance provides coverage for first-party liabilities for on-site and off-site environmental cleanup and remediation, and third-party liabilities arising from lawsuits brought by others for bodily injury, property damage or environmental cleanup. The liability protection afforded by PPL coverage can be tailored to the needs of the acquiring company—customized, for instance, to absorb exposures related to sudden and accidental environmental damage, or gradual pollution.

Acquiring companies also confront several unusual risk exposures that can be mitigated through insurance. For instance, since a target company's environmental liability policies may expire or go into runoff mode upon closure of an M&A transaction, acquiring companies should consider filling these potential coverage voids with new insurance policies before the deal closes.

Of particular concern to directors and officers is the risk of a securities class action in situations where the acquiring company inherits legacy environmental liabilities that subsequently cause a material slide in its stock price. Directors and Officers (D&O) liability insurance offers critical protection to executives sued in such cases, although coverage must be in place prior to the M&A transaction closing.

Other considerations in this regard include the fact that D&O policies cover only those claims that are first-made and reported during the policy period. If the policy period or an extended reporting period ends, so does the ability to report a claim or potential claim. This timely notice is a critical issue in the context of a merger and acquisition. Most D&O policies state that coverage will automatically terminate if more than a stated amount of assets are sold, or if another person or company acquires the right to appoint more than a stated number of directors to the board. The policy stays in place until the end of the policy period, but only for reported claims for acts that took place prior to the acquisition.

Although most D&O policies have terms of one year, claims can often be brought as long as six years after a transaction closes, depending on the governing statute of limitations. To address this possibility, many target companies purchase a non-cancellable, pre-paid D&O policy, known as run-off or "tail" coverage, with a six-year duration. This is a vital consideration, as many acquiring company D&O policies do not provide coverage for directors and officers as executives of the target company prior to the merger or acquisition. Many companies also purchase an additional layer of insurance for directors and officers, called Side A, or CODA, insurance.

> Awareness of D&O policy term changes, notice requirements, statutes of limitations, and the target company's D&O policy terms and conditions is imperative to assess environmental liability in the aftermath of a merger or acquisition.

Directors and officers of a target company that subsequently become executives of the acquiring company also will require D&O insurance, as the former target company's D&O policy provides coverage only for acts while employed by the then-target company. The acquiring company's D&O policy thus needs to address the forward-moving acts of these directors and officers in their capacity as executives of the acquiring company. "There are some nuances to consider in this regard, such as reviewing the acquiring company's D&O policy to determine if the executives are automatically added to coverage, or whether specific acts must be taken to provide coverage," said Mr. Fleischman.

Obviously, awareness of D&O policy term changes, notice requirements, statutes of limitations, and the target company's D&O policy terms and conditions is imperative to assess environmental liability in the aftermath of a merger or acquisition.

Conclusion

Directors and officers along with their risk managers that are considering their companies' and their own post-M&A transaction environmental liabilities should aspire to leave no ambiguities on the table. Certainly, the risk profile of the combined entity will change post-transaction, in some cases substantially. The threat of share price volatility in the months after a deal closes typically is higher, possibly inciting shareholder or subsequent acquirer lawsuits against directors and officers for misrepresentations, breaches of fiduciary duties or violations of the securities laws. This enhanced financial exposure argues for accessing the services provided by an experienced D&O insurer. Such carriers have a one-stop approach to insuring environmental risks and other liabilities inherent in a merger or acquisition. They offer the required responsiveness to facilitate the closing of transactions within set timetables, minimizing the possibility of the emergence of unexpected and uninsured post-transaction liabilities. As M&A activity picks up as expected, and more countries enact broader and stricter anti-pollution laws, such liabilities are sure to increase for directors and officers.

The ACE Solution

ACE USA's Mergers & Acquisitions practice is focused on helping brokers and their clients identify the casualty, environmental, property, and management liability challenges inherent in their M&A activities and providing a range of insurance and other unique risk transfer solutions. ACE sees its role as a strategic partner for its clients and, as a result, this approach helps mitigate contentious claims or service issues. The company's global M&A practice concentrates both on strategic mergers and acquisitions and private equity deals. It provides insurance solutions and manages the relationship between the private equity firm, ACE and their portfolio companies. For example, a portfolio approach may be optimal in the areas of property, accident & health (A&H)

and management liability to create economies of scale and greater purchasing power.

The portfolio approach also applies to the claims administration. By combining insurance programs from disparate insurance carriers and/or claims administrators after a merger or acquisition, greater synergies can be realized through the use of a single third party claims administrator (TPA), particularly one with expertise and a substantial geographic footprint. ESIS® part of the ACE Group, works with clients to analyze their claim histories and trends using sophisticated data analytic approaches that help pinpoint cost drivers and recommend strategies that can help avoid or mitigate losses.

Within the M&A practice is a team of risk management, claims and underwriting specialists who work together to help clients navigate the uncertain M&A landscape. This coordinated delivery of M&A insurance solutions is underwritten by an insurance carrier with unquestioned financial strength and stability, yet another reason to consider ACE.

ABOUT THE AUTHORS:

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Scott Meyer is Division President of ACE USA Professional Risk. With more than 20 years of underwriting and risk management experience in the professional lines insurance arena, Mr. Meyer joined ACE USA in 2008. He previously held several senior leadership positions at AIG, most recently serving as President, Financial Institutions Group, Head of the Mergers & Acquisitions Insurance Group, and as Senior Vice President, leading efforts for the company's Strategic Risk Group. He previously co-founded a Managing General Agent (MGA) specializing in transactional risk management products. From 1997-2000, Mr. Meyer served as Director, Financial Services Group at Aon. He is a graduate of New York University, where he received a Bachelor of Science degree in Economics.

Jon Peeples is Vice President of ACE Environmental Risk. He leads a team of specialized product and service experts who concentrate on environmental liabilities for private equity groups, real estate investment trusts, financial institutions, property owners, and strategic mergers and acquisitions.

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Endnotes:

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