It's not easy being green

How private equity should manage environmental issues

Environmental matters have financial, operational and reputational impacts. Private equity investors need to take a commercially driven approach to environmental due diligence, which focuses on understanding the business performance implications of environmental issues.

Irrespective of whether one accepts the socio-moral argument that companies have an ethical obligation towards the environment, a proactive approach to environmental risk management is essential because failure to comply with environmental regulation (or to adequately respond to environmental risks) can have big financial implications. Clean-up works (such as soil and groundwater remediation or the removal of asbestos) could run to tens of millions of euros. Companies also face the prospect of criminal or administrative fines for non-compliance. This has an obviously detrimental effect on the equity returns enjoyed by a company's investors.

Company directors or officers also face the prospect of personal liability. In England and Wales, liability could fall on a director if their act or omission was the cause of the offence, or if the offence is attributable to their consent, connivance or neglect. If an investor has the power to appoint directors to the board of the target, it should be aware that those appointees could suffer personal liability if environmental risks are not well managed. Knowledge about those risks, and the ability to properly respond to them, will depend on the level of due diligence undertaken.

Proper management of environmental issues, as an aspect of good corporate governance, is also important for a company's reputation. In May 2006, a coalition of non-government organizations paid for a full-page advertisement in *The Washington Post*, promoting a spoof award to ABN Amro for "outstanding environmental hypocrisy" due to the bank's part in the Russian Sakhalin II oil pipeline project. Given the international pressure for companies to increase their level of reporting on environmental matters, brand damage to a target because of its approach to environmental issues must be factored into an investor's due diligence analysis.

What is required?

Due diligence is carried out to elicit information. It enables the investor to have as complete an understanding of the target business as possible, to decide whether to proceed with the investment and to highlight liabilities and risks that might affect pricing, reputation or operations. The results of the due diligence exercise then feed into the contractual negotiations and allow the investor to evaluate how to address the risks identified.

The due diligence required for a proper analysis of environmental risks will vary from deal to deal. Much will depend on the nature of the business and on the mechanics of the investment. With business disposals, it is becoming increasingly common for vendors to prepare a suite of divestiture environmental due diligence documentation on which the investor may rely. If properly prepared (and if the terms of reliance are not too restrictive), these documents could reduce the amount of independent due diligence required, the main task being one of review and commentary by the investor's specialist advisers (lawyers, environmental consultants, accountants and insurers).

If divestiture due diligence documentation is not provided, the investor will need to choose an appropriate scope of work for its advisers. This will involve setting a materiality threshold in identifying and reviewing big issues. Private equity investors would be wise to allow some fluidity in the concept of what is and is not material. For example, a plant might be required to upgrade its cooling towers to improve emissions to air at a cost of €100,000. This capital expenditure might be material in the context of the target business. However, it might also be material if a target business faces five prosecutions for non-compliance with environmental law where each fine has a ceiling of €20,000 because, in aggregate, this would amount to potentially €100,000 of liabilities for similar environmental matters and because the number of prosecutions might suggest poor risk management at the target business.

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Not every environmental issue will be material, nor should every environmental risk be reviewed or analysed. This will partly depend on timing: if the investor is part of a competitive auction bid process for the target business, the ability to undertake a complete environmental review might be limited. Another factor is cost: if the investor's advisers review and report on every environmental matter, the transaction costs (in terms of advisers' fees) might be prohibitive and dampen the transaction's appeal. A middle ground must be discovered between enough due diligence to properly understand the environmental risks faced by the target business and excessive due diligence that is not commercial or practical. Private equity investors face an additional hurdle not faced by a trade buyer or trade investor, which can be labelled the *comfort barrier*. Not only must private equity investors have a proper understanding of the environmental risks associated with the target business, but they must also feel comfortable that the risks are typical (or at least not wildly atypical) of the target business industry.

There are no hard and fast rules on what environmental due diligence is or is not appropriate, but at the very least the target business should be analysed from an environmental point of view for:

- regulatory compliance;
- soil and groundwater issues;
- legal matters; and
- business upsides.

Regulatory compliance

An analysis of compliance with environmental regulation will highlight operational improvements required to bring the target business into line with legislation. Certain non-compliance matters might only require management time or minimal cost to be remedied (and so have little impact for the investor). Others might require the outlay of substantial capex (either ongoing or when a site is decommissioned or closed). Regulatory compliance matters are often best analysed by an environmental consultant with appropriate knowledge and technical expertise of the target business sector. Where breaches of, or non-compliance with, environmental law occur, the due diligence exercise should also highlight any actual or potential enforcement action by the relevant regulatory authorities.

Permits and licences

A business might require a licence or permit from a regulatory authority for a number of reasons, for example, to discharge waste, to abstract water, to store or handle hazardous materials, or to emit to air. The due diligence process should highlight what permits are required, whether these have been obtained and if they are complied with. Attention should also be paid to the financial implications of the permits. For example, certain target businesses subject to the EU Integrated Pollution Prevention and Control permitting regime might need to provide financial assurances (by way of bond issue or parent company guarantees) to the appropriate regulatory authority regarding closure and aftercare costs associated with their operating plants.

Waste

The EU has taken a coordinated approach to the management of waste. It is aiming to cut the amount of rubbish generated, through new waste prevention initiatives, better use of resources, and encouraging a shift to more sustainable consumption patterns. The EU approach is three-pronged: (1) waste prevention; (2) recycling and re-use; and (3) improving final disposal and monitoring. The EU Waste from Electrical and Electronic Equipment Directive and the EU Restriction of the Use of Certain Hazardous Substances Directive place waste management obligations on certain manufacturers and importers.

Hazardous substances

Environmental due diligence will identify what hazardous substances are stored, used or handled on site and whether the use, storage and handling is compliant with legislation and good industry practices. One of the largest concerns in this area is asbestos, both in terms of how the substance is managed (if present at the target business properties) and because of the possibility of exposure-related claims. In December 2006, the EU adopted a new Regulation on the Registration, Evaluation and Authorization of Chemicals (Reach). The Reach regime will have a broad impact and is the most comprehensive overhaul of EU chemicals policy in decades, aimed at ensuring greater safety in the manufacture and use of chemical substances.

Health and safety

The due diligence process should include assessment of the mechanisms in place to manage occupational health and safety issues, including organization, staffing and training as well as the presence (or otherwise) of a comprehensive health, safety and environmental management system (such as EMAS or ISO 14001). The review should also comment on work-related accidents, illnesses and occupational diseases.

The due diligence process should highlight where the EU target business owns, controls or has an interest in non-EU affiliates. The private equity investor must have a sense of what regulatory issues apply to those affiliates under different, and potentially more invasive, environmental regimes (such as in the US).

Soil and groundwater contamination

Because of long industrial use, hundreds of thousands of sites across Europe are either contaminated or have the potential for soil and groundwater contamination. The significance of this depends on the risks posed to the environment (land, water, air and living organisms) and the applicable environmental remediation regime. Soil and groundwater contamination risks tend to fall into three pockets:

1) Contamination of the target properties on the date of investment or acquisition.

2) Contamination of properties previously owned, occupied or otherwise used by the target business.

3) Contamination of third party properties at the date of investment or acquisition as a result of migration of contaminative substances from the target business' current or former properties.

If soil and groundwater contamination is a concern, environmental consultants should be engaged to prepare a series of reasonable worst case cost estimates for remediation, together with a risk analysis of how likely the remediation might be. Whether the consultants perform intrusive site investigations (Phase II studies) as well as a desktop analysis of environmental databases (Phase I studies) will depend on the target business vendors' permission. In a competitive auction, there is often no knowledge of the transaction at the individual site level and the vendor's advisers might be concerned that intrusive investigations by an environmental consultant could jeopardize the confidentiality surrounding the transaction. Timing is also a factor as laboratory analysis of soil and groundwater samples can take up to three weeks.

Properties formerly owned, occupied or otherwise used by the target business might still pose financial risk for the investor. Because of the EU principle that the polluter pays and the operation of certain member state contaminated land regimes, it is possible for the target business to retain liability for certain environmental matters at former properties (often referred to as legacy issues). It is difficult to determine with any degree of accuracy the responsibilities for contamination where a site has long been used industrially and by multiple operators. The matter is further complicated because it is possible for a party to contractually allocate its share of liability to another party or statutory liability allocation mechanisms might operate (dependent on the particular regime in the relevant member state). The due diligence exercise will need to drill down to establish details of the former properties, whether there was any actual or potential contamination at those sites at the time of disposal/closure, whether liability for the contamination risks was passed to any third party, and the likelihood that the target business will be responsible for, and/or required to, undertake remedial works on those properties.

Legal matters

Identification of environmental risks without a proper analysis of the legal framework to which they relate is, in some respects, meaningless. The legal due diligence exercise will focus on legislative and contractual mechanisms that will have an impact on the environmental risks associated with the target business. Investors from outside the EU (or those not as comfortable in the target's jurisdiction) might also require legal advice to put the regulatory environment into context. The review of the target's property, corporate and environmental documentation should seek to establish:

- where environmental liabilities will, or may be, allocated as a result of operation of law;
- whether these liabilities have been, or may be, apportioned to any other party contractually, by way of agreements on liability or indemnities;
- the existence or possibility of enforcement action or litigation by regulatory authorities;
- the existence or possibility of third party claims (whether under tort, contract, statute or otherwise);
- the existence and terms of any policy of insurance in respect of environmental matters; and
- whether there are any assurances or guarantees in respect of environmental matters.

Legal advice will also be necessary on divestiture, to ensure that the investor exits from the business without residual liability for environmental matters. The ability to exit a business cleanly depends, in part, on the sufficiency of pre-investment or pre-acquisition due diligence and the associated investment or acquisition contractual protections granted to the investor (some of which might be capable of assignment to the incoming investor or purchaser).

Potential upsides

In the context of a business environmental analysis and due diligence review, current and future environmental regulation or policy can exert a positive financial effect on the target business. The regulation or policy might lead to prospects for new business and/or it might have a detrimental impact on a competitor who, for whatever reason, is not as well placed to weather the change.

On October 30 2006, Sir Nicholas Stern, head of the UK Government Economics Service, published his report on the economics of climate change. This report concludes that the world has to act immediately on climate change or face devastating economic consequences, irrespective of the associated environmental impacts. A number of sectors will feel a financial pinch as they re-orient their businesses to respond to this global phenomenon: either because of capex outlay (for example, on plant or fleet upgrades) or because of the constraints of new legislation aimed at reducing environmental impacts (for example, the EU Emissions Trading Scheme). However, the sophisticated private equity investor might be looking to those areas in which there is the possibility of a gain, including, but not limited to, low-carbon technology industries, carbon capture and sequestration projects and the renewable energy sector. All too often the focus in environmental due diligence is solely on those matters that could have a detrimental effect on the financial, operational or reputational outlook of the target business. Private equity investors, and their advisers, should also focus their due diligence on possible upsides. An holistic approach to environmental due diligence is that best suited to provide the private equity investor with a proper understanding of the target business and target sector to which it commits funds.

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