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Environmental Exposure – Regulatory Compliance – Insurance Coverage (or not)

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Client Advisory
July 6, 2017 by Stephen M. Fields

After looking at numerous investment opportunities, you bite the bullet, assemble a syndicate of lenders and close on a leveraged buyout transaction resulting in control of the operating company target through the use of a holding company. You were careful in your diligence, having conducted a Phase I environmental investigation, with nothing significantly adverse to report despite the regular use in its business by the target of certain contaminants. Now fast forward, and, five years later, you have received an attractive offer to buy your interest from a strategic buyer. The buyer and its lenders proceed to conduct their own due diligence and, lo and behold, the contamination levels that were previously below reportable levels have, according to the buyer, exceeded permissible levels and have now reached groundwater. What is the consequence of this? How did it happen? Who caused it? What are the issues?

At the outset, is the verbal report from the buyer complete and accurate? Is there a lab report or confirming consultant report, in draft form or otherwise, in existence to support the allegation? What is the remediation cost and how long will it take? Have you violated any federal or state laws and are you continuing to do so? What obligations do you as the majority owner and current indirect operator of the tainted property have and to whom? Do you have any indemnity rights against the former owner? Did the contaminated groundwater migrate from an adjoining property? Will it migrate further into public drinking water? What insurance do you have and does your pollution policy cover the existing situation? In addition, the buyer, and its lenders have become nervous about the entire transaction, and, if they proceed, now wish to exclude the tainted facility from the purchase and are requesting a separate escrow, indemnity and insurance coverage.

Lots of questions – lots of uncertainty. What should you do and what are your alternatives?

First, you must ascertain the facts. The buyer has made an allegation which may or may not be true or be as severe as claimed. It hired a consultant which undoubtedly has an economic interest in participating in an expensive remediation effort. Do you want the buyer to control that process? If it proceeds with the purchase, the buyer itself is incentivized to reduce the purchase price and to create as large an escrow and indemnity as possible. Under many state and federal environmental statutes, once an owner or operator becomes aware of an "environmental condition" it has an obligation to promptly report same to the local authorities, which will then undertake their own investigation and make recommendations and/or issue directives as to what is required to remediate the property. The obligation to report an "environmental condition" to the local authorities does not generally arise until a final written report is rendered by someone expert in the field. As a result, a seller will often immediately engage its own expert for such purpose so as to control the process and costs involved and to initially render a draft report. If a pollution insurance policy is in place, in order to preserve coverage, you as the seller should immediately notify the insurer – especially if you wish to be reimbursed for any costs you incur, because the insurance company will want to be responsible for the cleanup and hire those who will do such work because of the discount it receives due to its ability to purchase in volume. It is also recommended that a formal claim be made in collaboration with the buyer before signing any purchase documents with the buyer so as to preserve such insurance coverage because numerous pollution policies have non-assignment provisions and so-called "contractual liability exclusions" from coverage which are triggered upon entering into indemnity agreements with the buyer. You also need to check whether a change of control is deemed to be an assignment under the policy. In the scenario outlined above, the buyer (which will purchase the entity that previously operated the tainted property) and you as the seller (if you retain the contaminated property in a different entity) will no doubt seek to obtain your own pollution policies. (Note that if you as the seller retain the tainted property as a stand-alone in a separate entity, it is possible that such entity will be treated as a real estate holding company and thus Foreign Investment in Real Property Tax Act [FIRPTA] rules will apply to any foreign limited partners of yours, which may require them to file U.S. tax returns.) Note also that buyer and seller will need to be aware of something the insurers call a "material increase in risk endorsement" provision contained in many pollution policies. Thus, in the example above, if the contaminated groundwater continues to migrate in the future, it is possible that the insurance coverage purchased will be disavowed by the insurer. Another caveat is that some of these policies permit the insurer to cancel the policy for any reason or no reason, usually upon 90 days' notice. As is apparent, careful review of the policy is essential.

Assuming an environmental disaster is not covered by insurance and indemnity rights are not available from a creditworthy indemnitor, do you as the private equity fund seller have exposure simply because you are the majority stockholder of, and control the board of, Holdco (a Delaware corporation), which is the sole member of Opco (a Delaware LLC), which previously operated the tainted property? Generally, environmental law respects the limited liability of the corporate form unless specific, unusual circumstances justify treatment of the businesses as a separate entity. There are two ways in which shareholders may potentially face liability: piercing the corporate veil, or where the shareholder is deemed under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and similar state statutes to be an "operator" of the subject property under environmental regulations. Neither of these doctrines applies solely because a seller is a shareholder. Certain courts (the Fifth Circuit for example) take a narrow view of corporate veil piercing in environmental liability actions. However, if the corporation is formed to perpetuate a fraud or where the shareholder's activity resulted in the liability, a shareholder could be held liable. While the rules of veil-piercing limit derivative liability for the actions of another entity, CERCLA's "operator" provision is primarily concerned with direct liability for one's own actions. As a result, an officer, employee or shareholder could potentially be liable if "they themselves actually participated in the wrongful conduct prohibited by the Act." *Riverside Mkt. Dev. Corp. v. International Bldg. Prods.*, 931 F.2d 327,330 (5th Cir. 1991). Liability does not extend merely because management had authority to operate or make day-to-day decisions. Board control does not change this analysis. "Operator" liability extends only to those "persons" (including corporations and other entities) who "managed, directed or conducted operations specifically related to pollution, that is operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations." *United States v. Bestfoods*, 524 U.S. 51, 66-67 (1998).

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