Enviromental Aspects of Acquisitions and Mergers

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Acquisitions. Mergers. Buy-outs. Call them what you will, our industry seems to be participating in the national trend toward consolidation of business units. Consolidations have long been a part of our corporate culture and national economy. Such business activity is driven by factors like product and marketplace synergy, revenue and income growth, elimination of competition, increased capacity and posturing for an IPO (Initial Public Offering). Such a consolidation transaction is typically referred to as an "A&M"-a common acronym for "Acquisition and Merger."

In the PWB industry, where the majority of participants are small, privately held companies, an acquisition, merger or IPO represents a "cashing out" opportunity for the founders/ownership. The industry is suitable for major consolidation activity—it has been for this entire decade. The characteristics creating that suitability include:

- Most industry participants are small businesses (less than $25 million annually)
- Most businesses are privately held (and most of those very closely)
- Very little—if any—product differentiation
- Production capacity is greater than demand
- High barriers to industry entry

One of the most critical, and often overlooked, considerations in any A&M is environmental compliance and the extent of any potential environmental liabilities. Environmental issues can significantly affect the financial evaluations used in an A&M. Key to obtaining value for financiers and/or stockholders is identifying environmental issues as early as possible in the A&M process, and acting in accordance with that knowledge during each stop along the way. This article is

intended to provide executives who are involved in, contemplating or even dreaming of an A&M or IPO, with the knowledge necessary to manage any environmental issues that may arise in the process.

How to Get Started

Most A&Ms involve project "teams," assembled according to the specific corporate structure involved, on both sides of the transaction. This team commonly consists of company officers, attorneys, accountants and the occasional trusted advisor or mentor. As early in the process as possible, the prudent company also adds to their team an Environmental Specialist (ES). This individual participates in much the same manner as other team members who are not company employees — as a consultant compensated on a project basis. Many companies actively retain the services of all the non-employee team members as a matter of regular business. For the same reason that you would not dare attempt an A&M without the counsel of an attorney, you should not attempt an A&M without the counsel of an ES.

What to look for First

Once you have an ES in place, there are three critical areas he will want to look into as early as possible in the A&M process- real estate, local and national regulatory compliance, and the general corporate attitude concerning environmental issues.

Real estate is, of course, the land and buildings which the target business occupies, whether owned or leased. There are a couple of important points to bear in mind concerning real estate. The first is that for purposes of environmental liability, there is little distinction between leased and owned real estate. Laws vary from state to state concerning responsibility for clean-up between a landlord and industrial tenant, but in all cases the landlord can sile a tenant for contamination of leased real estate. In this respect, the leased facility might represent a greater exposure to liability than those owned.

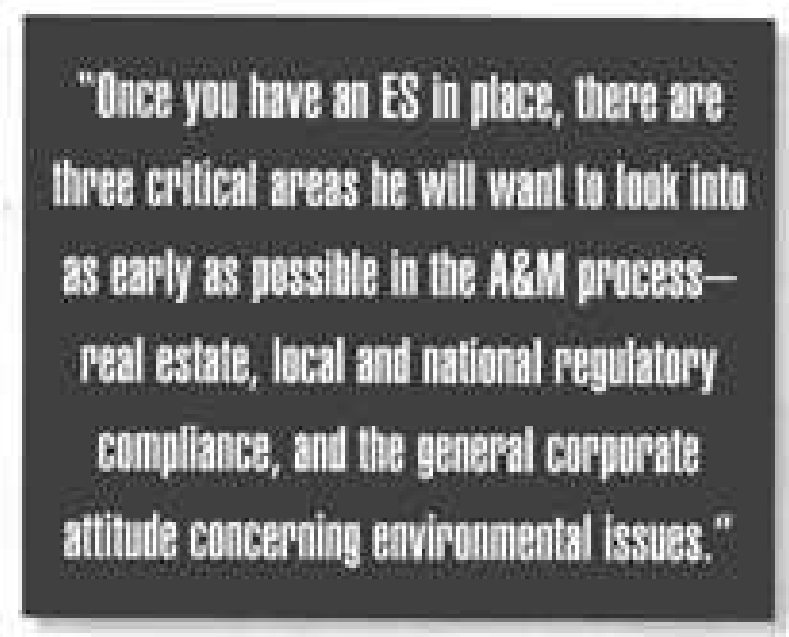
A second important consideration while examining real estate is that the buildings and other improvements are as important as the land (soil and groundwater). Facilities can commonly by found where there was little or no contamination to the soil or groundwater but where so much hazardous material had been "splashed" around, that the walls are rotted and/or extremely contaminated. In such a situation, the building, or at least part of it, is literally a pile of hazardous waste. It may be shaped like a building, but it is built of contaminated, and therefore hazardous, material.

Another critical area that will need to be evaluated is regulatory compliance. When examining this area, your ES will want to thoroughly check out:

- Physical assets like plant layout and design
- Operational practices like manufacturing procedures and materials handling
- Documentation — permits, reports, plans and procedures

The ES will pose some very important questions when examining the area of regulatory compliance. Lack of compliance, even if undetected by regulatory authorities or overlooked in terms of any enforcement action, could represent a significant liability. Obviously, recent or on-going enforcement actions are a major issue. If, however, a lack of compliance is detected, but no enforcement has occurred, your ES should interview personnel to find out about recent interactions with regulatory authorities. Enforcement action may be just around the corner. Likewise, unenforced compliance violations may represent future lawsuits from disgruntled employees or neighbors.

The remaining area, for lack of a better term, will be called "corporate environmental climate." Investigating this area will consist primarily of interviews with various personnel of the target company. It is important to conduct interviews with all levels of employment, not just management or supervision. Labor can often reveal a number of issues that others are not even aware exists. The issues explored concern how well the two companies will fit together. Widely varying attitudes toward environmental issues can reveal an area where it may be very difficult to blend the operations, resulting in significant post-acquisition costs. These questions are important in determining the cost of *assimilation* once the target has been acquired. This area is often neglected, and it is vitally important.



What is an Assessment? What is an Audit? Huh?!

Various terms apply to an environmental investigation of a business or property. The most common terms are "assessment and "audit." Assessments are broken into phases, the definition of which may differ by the organization or agency defining the term.

Because of the occasional differences in the definition of the terms, we proffer further definitions tor our purposes. We acknowledge work by both professional organizations and regulatory agencies to formalize the definitions. Their efforts have narrowed the meaning of these terms, and our definitions are simply. for the convenience of this article, not because of any inherent disagreement with the proffered definition.

The term "assessment" has come to be used almost exclusively in association with real estate transactions or evaluations. It generally refers to the process used to determine whether the soil or groundwater has been contaminated. Most state laws require an assessment of some sort when real estate changes hands. The variation between the states lies primarily in what should be done with the information contained in the report on the assessment. Some states reqiiire remediation if contamination is found, others simply require that the information be revealed and incorporated in negotiations. However, as a practical matter, rarely does contaminated real estate change hands since it is virtually impossible to get financing for the

chase of contaminated land. Therefore, cvcn in those states that only require the inforination be disclosed, remediation of contaminated land is the norm.

Assessments are conducted in phases in order to limit the expenditures to only those which are necessary. This will become apparent as the phases arc explained. A Phase I assessment generally refers to all the assessment activities that can be reasonably conducted based on readily accessible sources of information, arid without doing any sampling or testing. Reports from Phase I assessments normally include information about:

- The basic geology of a site.
- The hydrology of a site (this information is usually obtained from government sources).
- A recount of the historical use of the land—as best as possible from title searches, local historical records, etc.
- Any reported remediation or testing activity conducted at the site at some other time
- A basic description of current activities on the property and neighboring properties.
- A report on the findings of a physical, visual inspection of the site,
- A conclusion as to the probability (non-numerical) of contamination of the site, including a recommendation on any further testing and investigation which may be necessary.

Based on the findings of a Phase I assessment, a Phase II assessment may or may not be indicated. If the Phase I shows that the soil or groundwater has a reasonable possibility of contamination, it is necessary to test it to confirm or deny that possibility. The contents of a Phase II assessment will depend very highly on the findings of the Phase I. For example, if the Phase I concludes that a few isolated spots might be contaminated, the Phase II would probably begin by taking a few cores at those spots and testing them for the probable contaminates. Further Phase II testing might, depending on the results of those first tests, be undertaken to determine the extent of contamination.

If Phase I were to conclude that an area of some size was almost definitely contaminated, then the Phase II might start by establishing a grid over the contaminated area and sampling at various grid points to determine the extent of contamination. Note that such a grid would be three dimensional, including depth. Phase II should be undertaken only after careful consideration of the purpose of the exercise.

In some circles, Phase II assessments are discussed, although this terminology has lost favor and generally refers to rcmcdiation activity.

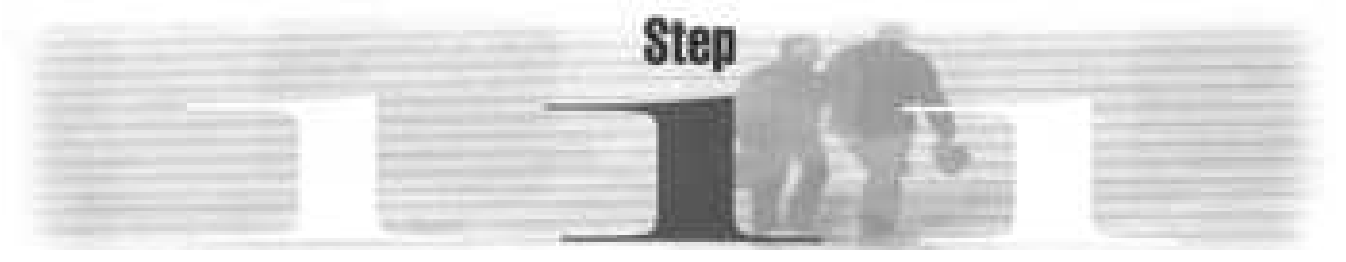
Another term that is commonly used is "Environmental Audit." The definition of this term is far more nebulous, and has not been as clearly defined by the legal processes as "environmental assessment." Typically, an audit refers to a review of the general environmental procedures of a company. Thus, an audit will investigate all aspects of a target's activities, but will be less intense in the specific area of potential contamination to the general environment than an assessment.

An environmental audit will look into the permits a company has, its general business practices, its history of payment of environmental fees, its work procedures and practices, and anything else that would give one a clue about the company's attitude and actions concerning environmental matters. The focus of an audit is to develop a complete picture of the business's environmental status, both in reference to regulation and to contamination.

Although the details of an audit are not nearly so well defined as it is with an assessment, its breadth is much larger than an assessment. Therefore, an audit is a more useful tool in the acquisition of a company.

Okay–I Want to Buy a Company, What Should I Do?

The authors have been involved in the acquisition process on several occasions and have developed a protocol, as described herein, that seems to work for them and their clients.



Find an Environmental Specialist

Unlessyou are buying a business utilizing the same processes you are using and have an employee whosejob it is to stay on top of environmental technology and regulation, you will probably have to look for your ES from the ranks of consultants out there. Consultants can typically assist you in your acquisition better and more cost efficiently than you can do it with your own resources.

There are two qualifications that are important to remember when hiring a consultant as your ES. The first, and by far most important, is how well the consultant fits with you ancl your people. Can they communicate with you and vice versa? Do they understand your corporate environment and goals? Do they understand that you are interested in the engineering and regulatory aspects of issues only as they relate to business, or do they view those matters as the end to themselves?

Secondly, the knowledge of the ES about the processes and materials used by the target company should be a paramount consideration. The consultant that has to spend a lot of time learning what a facility is doing rather than examining how they are doing it will be costly indeed.

The usual assortment of other qualifications should also be reviewed. It is always wise to check references, look at previous experience and review previous written work—they will need to provide you with the information in a concise and useful manner. In some situations the consultant may become a key player in your acquisition process.

A Facility Inspection and Identification of Issues

After the initial contacts have been made with your potential target, you should probably involve your ES. The ES should visit the target facility or facilities and conduct an inspection designed to identify what, if any, environmentally related areas and issues need further examination, investigation and, ultimately, negotiation.

There are only a couple of essential questions to be answered at this point. Does the target have any environmental exposure? If so, where is it? The point of this first inspection is not to discover all the issues in detail, but rather to obtain the necessary information to develop a roadmap for the rest of the investigations and negotiations.

Typically, the ES will not have to spend more than a few hours at a facility to accommodate these limited goals. Chances are this will occur early enough in the process that the ES's true purposes may need to be hidden from employees at the target. The consultant will probably need to meet with some of those employees, so developing an explanation that everyone can live with is important.

At the conclusion of this inspection, the ES will produce a report that outlines any environmental concerns that may exist. Many businesses do not have environmental exposure. The process described here should probably be undertaken whenever the target is a manufacturer of any sort, but may not be necessary when you are acquiring a sales organization. But even if the target is a manufacturer, some operations do not involve the use of hazardous materials or have big environmental exposure. Nonetheless, the process should be taken this far, even for businesses that do not have any apparent concerns. For example, something as innocuousas a machine shop can have environmental trouble if they do not handle their cutting oils properly. It is worth the money to have your ES give even the innocuous looking manufacturer a "look-see.''

Meet, Negotiate, Discuss

Once you have a list of concerns and areas for further action, it's time for serious considerations and discussions. You will have numerous options. The one you choose will depend on your desires, the desires of the target, the advice of your ES and financial advisors, and any other factor that seems pertinent to the situation. A few examples will help illustrate the multi-option nature of the situation at this point.

Suppose you are buying a one-facility business. The owner of the business the land and building in his own name. To date, your discussions have been about purchasing both the company and the real estate. On inspection, it is determined that there is a reasonable possibility of contamination to the soil and an assessment is advised. Depending on the state you are in, you may have certain options. For example, you could purchase the business, but not the real estate. The real estate could be leased with a clause holding you harmless from any clean-up. In some locations, the "hold-harmless agreement" may not be binding, but in others it can be a great idea.

Even after you decide to proceed with the assessment, you have a number of options. First, who will pay for the assessment? Typically, this cost belongs to the seller, but there may be good reasons for the buyer to pay for at least part of it. You may want to make sure a consultant or engineer of your choice does the work, for example. Once the assessment is done, depending on your location, you may want to buy the building and not perform a clean-up. Assume the assessment indicates there is contamination but that there is little possibility of it migrating outside of the property for a long time. You might buy the real estate at a price which takes into consideration the cost of clean-up. You can accomplish the clean-up during a time when it is more convenient.

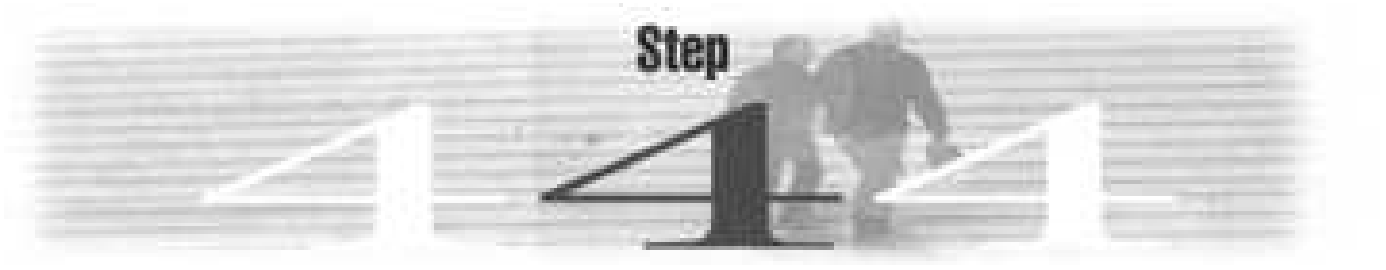
Consider another example. You are contemplating the purchase of a multi-facility company. The audit shows a high probability of contamination to a leased facility. This picture may be complicated by the fact that the lessors, whom are often passive investors, may have been collecting rent checks for years while completely ignoring their liability for a clean-up. Your options are many. For example, you could proceed through the assessment and remediation process and buy the company free and clear. The drawback is the process might take a year or longer with the lessor probably unhappy all the while. The seller should pay for clean-up but often does not wish to finance it. A more

straightforward option might be to buy the facility from the lessors at the same time you buy the business and deal with the issues at your leisure, if local regulation will allow you to do this.

In another example, a business has operated without benefit of the proper sewer permits. The simplest thing to do would be to make the seller settle all matters prior to your obtaining the business. However, the seller may, again, not wish to finance the costs. Another approach might be to purchase the customer list and physical assets, but leave the seller with the corporation and liabilities thereof. You would then need to obtain all necessary permits as a new company.

The point of all these examples is that there may not be a straight line from Point A to Point B. In fact, it may not even be important to get a quantitative answer to the liability question. Once the ES has inspected the facility(ies) and identified the issues, you may decide on options that do not require further study, investigation, action, or anything else-even if there are some environmental issues found.

As you gather your various advisors, the first question you are going to want to ask is "Do we need further data?" If the answer to this question is "yes," then you need to ask "What do we need to know?" These questions are not as simple as they seem. As has been illustrated, you have many options and gathering the information can be a very significant cost of the transaction unto itself. Therefore, you want to limit the need for data to only that which is absolutely necessary.



Execute

Once you have decided on how you want to proceed, you will want to make sure you have the right people doing the right things. Different environmental engineering and consulting firms do different things well, but most can do anything. You will want to make sure that you take advantage of their specialties, and your ES should be the best person to help you make those decisions.

Iterate

After you have taken the next few steps you will want to again review the data and decide on the further steps. Two important things to remember during this process are that the picture may change radically as more information becomes available, and this process can take on a life of its own.

Since the picture is prone to radical change, you need to stay on top of the data so you can respond to that changing picture. Staying flexible is important- which leads to the other important issue.

With all of those consultants and engineers roaming around, it is very possible for them to get carried away chasing every small lead and surprising you with a big bill. Constant and frequent review of all the data will help you stop it before things get too far. Your ES will be the key "go-to" person in this process.

When buying a business that has facilities which use hazardous materials, the environmental liabilities of that business must be an important part of the decision-making and negotiating processes. You will need expert help to identify and qualify those liabilities. You will need to control the process by which that information is gathered to get as much information as you need, but no more. You will want to examine creative options to deal with the issues raised and not simply proceed with a "brute force" buy out. Doing these things will result in your buying a business that you will like, at a price you will like.

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