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Seller -Targeted Guidance for Successful Environmental Due Diligence

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Purpose of Seller Due Diligence

Buyers and sellers, while seeking the same goal of closing the deal, clearly have different objectives to arrive at that common end.

Source: Deloitte Corporate Finance Inc.

A buyer will look to uncover risks and liabilities as part of its analysis to evaluate whether the target can be integrated into their current business plan. A seller, however, will strategically seek to uphold its company's value to acquire the highest successful return on exit.

All too often, due diligence findings and demands will be dictated by the prospective purchaser. Whether real or speculative, a buyer can sometimes seek to gain leverage during transactions by making doomsday or worst-case claims that can impact a seller's return on investment (ROI), or in some cases can even cause a deal to collapse.

Proactive sellers can reduce the risks of buyer-driven delays or setbacks before the due diligence process even begins. If buyer concerns can be assessed and quantified, then a seller can anticipate them and create a strategy to plan for and manage those concerns.

A look below shows this division in mindset.

	Buyer	**Seller**
Concerns	• Understand potential liabilities to put them in context with business plans • Avoid/manage liabilities related to pre-closing operations • Satisfy lender concerns	• Complexities and surprises that cause delays • Purchase price reductions and decreased ROI • Legacy liabilities and financial obligations
Approach	• Acquire as much information as possible • Drill down on potential issues • Input on remedies and place legal and financial burden on seller to resolve issues	• Control information flow • Internal review to identify or simplify material issues • Resolve or frame issues pre-transaction to speed transaction and maximize return

Consider Potential Risks from Buyer's Perspective

While a seller's primary goal is to maximize their ROI when exiting or divesting a business, a buyer's plan for the acquired business can be based on varying investment themes, which can affect how potential risks would be managed.

When considering potential risks from a buyer's perspective, there may be multiple strategies for managing such risks. For example, in certain investment schemes, managing environmental liabilities through a consistent annual cash flow may be the desired strategy for controlling costs, whereas under an alternative investment strategy, front-loading environmental budgets so that liabilities are eliminated before a future exit would be more advantageous. Both could potentially manage risks from a legal perspective, yet each provides a different financial ad- vantage that can factor into the buyer's future investment plans.

It's also important to consider the buyer's ability to manage environmental risks. Strategic buyers in a similar industry, and with in-house environmental health and safety (EHS) capabilities, would be in a far better position to take on environmental liability than a financial investor with a diverse portfolio. As such, financial investors may be more risk averse than a strategic buyer.

Finally, it is important to consider the evolving investment climate. Sustainable businesses that are perceived to be more environmentally friendly are in greater demand than those not meeting these criteria. Public opinion, whether broadly defined as the community as a whole, or narrowly defined as the company's customer-base, can be critical in evaluating the impacts of EHS matters. It can determine whether a buyer ultimately wants to invest in a business.

As a seller, it's important to consider these elements in preparing a business for sale. Understanding the current status of the business with regard to environmental liabilities and ongoing compliance risks is critical to building a potential risk profile and providing a framework for managing these concerns when taking a business to market.

Critical Seller Tasks Before Inspection Period

With recent global trends showing higher rates of deals failing to complete, a determined seller must do everything possible to ensure that the transaction inspection period progresses smoothly to achieve a successful closing.

One way to do this is to ensure that potential risks and liabilities have been considered and managed before taking a target to market.

Key tasks a seller should perform to streamline buyer's due diligence include:

Gather Documentation Compile all EHS-related documents, including permits, regulatory correspondence, plans and prior assessments. Ensure there are no missing documents that set the stage to demonstrate EHS compliance and manageable environmental liabilities.

Perform Internal Diligence Consider performing standard environmental practices early, to identify potential issues before they are brought to light by a buyer down the road. Consider the following:

- **Phase I ESA** Identifies potential liabilities associated with known or suspected contamination.
- **EHS Compliance** Evaluates gaps in environmental practices or record keeping that could result in violations or fines or require CapEx to address.
- **Exit Audit** Reviews facility operations to identify potential property impairments that would need to be corrected as part of vacating space or a shutdown.
- **Corporate Legacy Review** Evaluates potential retained liabilities related to formerly held properties or off-site disposal practices.

Critical Seller Tasks Before Inspection Period (continued)

Fill in Data Gaps Use the results of internal diligence to identify gaps and provide a complete picture of the EHS compliance and liability status of the company. Use industry tools to fill in material gaps.

- **Phase II ESA** Tests media above and below ground for comparison to regulatory standards and developing a baseline of site conditions.
- **EHS Compliance Management** Application submittals for missing or expired permits and written management plans to satisfy regulatory obligations.

Quantify Liabilities and Frame Risk Review the results of internal diligence and highlight "unknowns" after the data gaps have been filled. Evaluate liabilities to monetize and prioritize risk in the context of the current divestment plan. Frame issues by taking into consideration future business plans for potential buyers. Provide context for the risk management conclusions, which include the above steps as supporting rationale.

Investigate Potential Risk Management Scenarios For material risks identified, establish realistic budgets and timeframes to resolve known matters and provide management strategies such as insurance products or draft indemnity provisions for latent liabilities.

Prepare a Complete Picture Design your information presentation to potential buyers with purpose. Include a discussion of EHS management in management discussions, and consider information flow carefully. Provide documents that support risk conclusions and demonstrate a proactive approach to EHS compliance.

By taking these steps, sellers can better position themselves for negotiations with potential buyers. A thoughtful analysis of risks and liabilities shows buyers the company has the tools in place to manage risk going forward, and presenting logical quantifications of potential liabilities can minimize buyer requests for financial adjustments to the offering price. Presenting succinct but complete information to support these conclusions will lead to shortened diligence periods because buyers will have information readily available with which to evaluate how the risk picture fits in with their business plans.

Case Example: Underutilized Bus Facility

Situation

- Bus-maintenance operator sought to sell its underutilized facilities across the U.S.
- Facilities typically had up to 80+ years of industrial operations
- Facilities had been visibly neglected for years, which looked to tarnish the value of the assets

Approach

- Internal audit performed on existing documentation to identify those facilities with the highest potential for perceived liabilities and buyer pushback
- Earmarked facilities where best management/housekeeping activities were implemented
- Testing conducted at select facilities to better understand potential for contamination to the property
- New Phase I ESAs prepared that appropriately framed known site conditions across the portfolio with an opinion of costs and escrow

Outcome

Framing the risks for known issues by seller allowed the buyer to get comfortable and close on the deal within an accelerated 45-day diligence period using the established escrow and indemnities

Case Example: Chemical Storage-Terminal Sale

Situation

- Facility previously operated as a bulk chemical terminal located in an industrial corridor since WWII
- Bulk chemical storage had since ceased and owner/operator wished to sell business and real estate
- Long history of chemical storage created a perceived black eye on the environmental condition of the site

Approach

- Conducted document inventory, which identified storage tanks that received clean closure
- Phase I ESA prepared, which framed the risk based on the site's likely industrial re-use and location within industrial corridor
- Universe of possible recognized environmental conditions (RECs) were reduced to specific locations and operations at the site based on an exposure route evaluation
- Opinion of costs developed to assess potential for impacts at the REC area and forecast costs for regulatory closure should contamination be found

Outcome

With seller's environmental review in hand, buyer conducted an expedited due diligence period that focused on clarification of outstanding REC area instead of starting from scratch with a comprehensive site review

Case Example: Retail Lease Termination

Situation

- Fortune 500 automotive retail service provider with leased sites across the U.S.
- Facilities have been in operation for so long that many lease agreements were executed prior to the enactment of federal environmental laws
- Operator often required to meet unrealistic lease terms when seeking to exit a lease

Approach

- Performed exit audits on operational facilities as the lease windows drew near
- The audits allowed the tenant an opportunity to resolve potential liabilities without interference
- Audits also identified decommissioning tasks required by the lease agreement so that the operator could efficiently schedule those activities by the time the lease was terminated
- Checklist prepared upon completion of audit's recommendations for landlord's benefit showed tenant addressed applicable requirements

Outcome

The audits serve as documentation to properly frame tenant's use of the site and limit landlord's request for additional work

Takeaways

The transaction process has enough challenges without having to worry about what the prospective purchaser may uncover regarding the environmental condition of your investment. While due diligence is typically thought of from the buyer's perspective, it is best to enter possible transactions prepared and conduct due diligence before taking the business to market. Not doing so can lead to losing material value during exit.

Seller-driven diligence provides a number of opportunities that can increase the probability of closing the deal on advantageous terms.

- **Proactive vs Reactive.** Leverage the deal by being the first to frame the narrative with clearly defined findings and a system to manage issues.
- **Don't be blindsided.** Anticipate concerns that a buyer will call out and reduce uncertainty on how issues will be handled.
- **Credibility.** Increase credibility with buyer by being prepared and showing mindfulness to buyer's concerns.
- **Protect.** Allocate risks using indemnities and insurance products that can allow seller to safeguard from post-transaction legacy issues.
- **Efficiency.** Minimize re-trades to preserve investment value and reduce prolonged negotiations.

Working with experienced professionals to assist with this strategic approach to seller diligence will put you in the best position for success.

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