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Due diligence in mergers and acquisitions involving chemical products

BY LYNN L. BERGESON

The scope of what diligence is due in any corporate transaction has evolved greatly over the past decade, particularly with respect to transactions involving chemical products.

Once upon a time, transactional due diligence involving chemical products, whether 'neat' (pure) chemicals, formulations or end-use products, typically consisted of a phase I or phase II environmental site assessment (ESA) focusing on identifying contamination derivative of chemical releases into environmental media as effluent, emissions, fugitive releases or waste, as well as quantifying the potential for such releases to pose litigation risks or regulatory enforcement, or require costly remediation.

Increasingly, parties to corporate transactions now continue to focus on

these liabilities and on the compositional elements of chemical products themselves as potential sources of liability and commercial disruption. This article explains why the transition to chemical product due diligence has been slow and offers a few tips to help assess what diligence is due in corporate transactions involving chemical products.

Background

Traditional corporate environmental due diligence has focused on identifying contamination and quantifying the cost of remediating contaminated groundwater, soil and surface water and attendant structures. Given the extraordinary cost of remediating contaminated media, and associated tort liability often joined at the hip with such contamination, parties to a corporate

transaction are well-advised to continue to pursue rigorously due diligence in these areas of potential liability.

ESAs are rooted in American Society for Testing and Materials (ASTM) standards that focus on the conditions of the underlying land and buildings that are part of a transaction. A phase 1 ESA is generally considered the first step in environmental due diligence and properly focuses on these big-picture assets. A phase II ESA is conducted when a site is considered contaminated.

These evaluations are more invasive and involve taking samples of soil, groundwater or building materials to analyse for the presence and concentration of various contaminants. A phase III ESA is intended to identify and define site contamination based on the findings and recommendations

of the phase II investigation. These investigations can involve sophisticated testing and sampling programmes intended to assess the feasibility of remediation technologies.

Traditional environmental due diligence has also focused on the compliance status of the target entity of the deal. Depending upon the nature of the business operations at issue, a range of due diligence considerations are considered. Whether the entity has secured all appropriate permits and government approvals (e.g., air permits, direct or indirect wastewater discharge permits, underground injection well permits, hazardous waste storage or disposal permits) to conduct facility operations is central to the compliance inquiry. The absence of or material deficiencies in a permit can be fatal to a deal.

Equally important is whether the target is determined to be in material compliance with all pertinent governmental approvals. The current US administration is aggressively pursuing non-compliance, and statutory penalties are stiff. Given the vagaries of federal and state government ‘penalty policies’, calculating penalties can be challenging. What is certain is that enforcement penalties are high and calibrated to deter non-compliance.

These traditional environmental due diligence tools offer enduring utility, particularly as scientific tools and new methodologies evolve to detect contamination at ever lower concentrations and to differentiate among previously indistinguishable chemical forms. These refinements have greatly increased remediation costs, the scope of the contaminants that require remediation and the universe of entities believed to be potentially responsible for the contamination.

Evolving chemical policy and regulation increasingly are informed by genomic and biomonitoring data, complicating due diligence. These data, and their presumptive relevance to human biological systems and environmental health, add another layer of complexity to the environmental due diligence framework. Advocates forging new theories of liability are now armed with

genomic and biomonitoring data that are capable of evidencing a causal relationship between chemical exposures and adverse human health and environmental effects. While quantifying damages alleged to be caused by chemical exposures remains challenging, the plaintiffs’ bar is advancing ever more imaginative legal theories redefining and expanding liability.

Expanded due diligence involving chemical product transactions

While traditional environmental due diligence tools are necessary, they are not sufficient. Traditional tools and approaches are rooted in identifying and defining contamination resulting from end-of-pipe chemical releases from manufacturing operations, and they often neglect to consider sufficiently, or at all, potential liabilities derivative of a chemical product itself. There are several reasons for this persistent blind spot in due diligence.

First, in the US, chemical product laws have not routinely been included as part of environmental due diligence. There may be a passing reference to the Toxic Substances Control Act (TSCA) and the Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA), but the relevance of these product laws to a transaction to chemical products is seldom understood or meaningfully explored. Typically, it has been limited to compliance with record-keeping obligations and has avoided the more challenging in-depth review of threats to the chemical product itself.

We routinely witness the causalities of failed due diligence involving the sale or financing of assets, including chemical products. The results are grim. Product lines generating significant profit are later found to be time-limited due to chemical phaseouts, or a key component in a critical formulation is found to be illegal in the US under the TSCA, forcing product suspension or withdrawal altogether, or a promising new product is dependent upon a component that fits the definition of perfluoroalkyl and polyfluoroalkyl substances (PFAS) effectively delaying considerably its commercialisation. The list is long and regrettable, given that the

consequences of failed due diligence are entirely avoidable.

Second, changes in global chemical product law and policy have evolved quickly, and due diligence practices have not kept pace. The TSCA, its European Union counterpart, the Registration, Evaluation, Authorization and Restriction of Chemical Substances (REACH) regulation, and the REACH-like chemical product frameworks emerging in many parts of the world are not well understood in the financial sector. An understanding of the compositional elements of chemical products and their legal, scientific and product stewardship implications is crucial to understanding the value and commercial lifeline of a product.

The global concern with PFAS contamination is a perfect example. The ubiquity of these substances in products and their persistence in biological and environmental systems make PFAS the quintessential cautionary tale. All too often, due diligence protocols neglect to identify these substances in product lines, and these protocols neglect to anticipate the next ‘emerging contaminant’ that portends commercial disaster. These are fixable problems, and the financial sector is urged to address them.

Developments are fast evolving. The US Environmental Protection Agency (EPA), for example, in late August 2022, proposed that two PFAS be designated as “hazardous substances”; a decision that, once issued in final, will exponentially increase remediation costs for which industrial stakeholders will be strictly liable under US cleanup laws.

Finally, global chemical product trends are critically important to identify and are often overlooked or trivialised in environmental due diligence. Circularity, product stewardship, sustainability and environmental justice are more than aspirations, and they have a quantitative dimension that is directly relevant to the commercial viability of chemical substances, the companies that make and use chemical substances and the products that contain them.

Advancements in genomics are equally applicable in targeting susceptible

subpopulations uniquely vulnerable to certain chemical exposures under initiatives designed to ensure environmental justice, a current prioritised area of enforcement activity in the Biden administration, and a growing source of tort liability and unwanted social media scrutiny.

Tips

Due diligence deficits are unforced errors. To prevent them, a few tips are outlined below.

Have a product steward on the due diligence team. Product stewards are professionals with broad knowledge of global chemical issues. A product steward should be part of the team from the beginning. The Product Stewardship Society offers a credentialed certification programme, the only one of its kind. Entering into a three-way non-disclosure

agreement should be considered, along with retaining the services of a neutral third party, to ensure the confidentiality of chemical supplier information.

Ensure due diligence protocols are current, detailed and tailored to priority products.

Global chemical programmes pertinent to industrial, intermediate, agricultural, biocidal and specialty chemicals should all be included in due diligence protocols. A regulatory chemist should also be part of the team to provide informed counsel on chemical components, their relative toxicity, global regulatory status and commercial longevity. Key products should be prioritised to accommodate the usually tight timeframes that apply.

Engage chemical product legal counsel. Chemical product law is its own domain, not to be confused with environmental law. Those who have practiced in this

space have differentiated their practice for years, and it is finally being recognised as a separate area of the law that offers unique value in many contexts, including in due diligence transactions.

Conclusion

Key to the success of any deal involving chemical products is a keen appreciation of the fact that the chemical products are both assets and potential liabilities. To ensure valuation is correct and mistakes are averted, a carefully calibrated approach to due diligence is necessary. Following these tips should help. ■

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