



presents

Environmental Warranties for Carbon Emissions: New Regulations and Developing Legal Trends

Mitigating Environmental Liabilities and Risks in Business Transactions

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Reed D. Rubinstein, Shareholder, **Greenberg Traurig**, Washington, D.C.

Troy S. Brown, Partner, Morgan, **Lewis & Bockius**, Philadelphia

Thursday, April 8, 2010

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12 pm Central

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April 2010

Environmental Warranties for Carbon Emissions

Mitigating Environmental Liabilities and Risks in Business Transactions

Reed D. Rubinstein
Washington, D.C



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Summary “Carbon” Due Diligence

- Regulatory Risks.
- Energy Costs.
- Potential/Actual Threats To Markets, Products And Supply Chain.
- The Costs And Profits Of Emissions Trading Schemes.

Background

■ Legal Framework

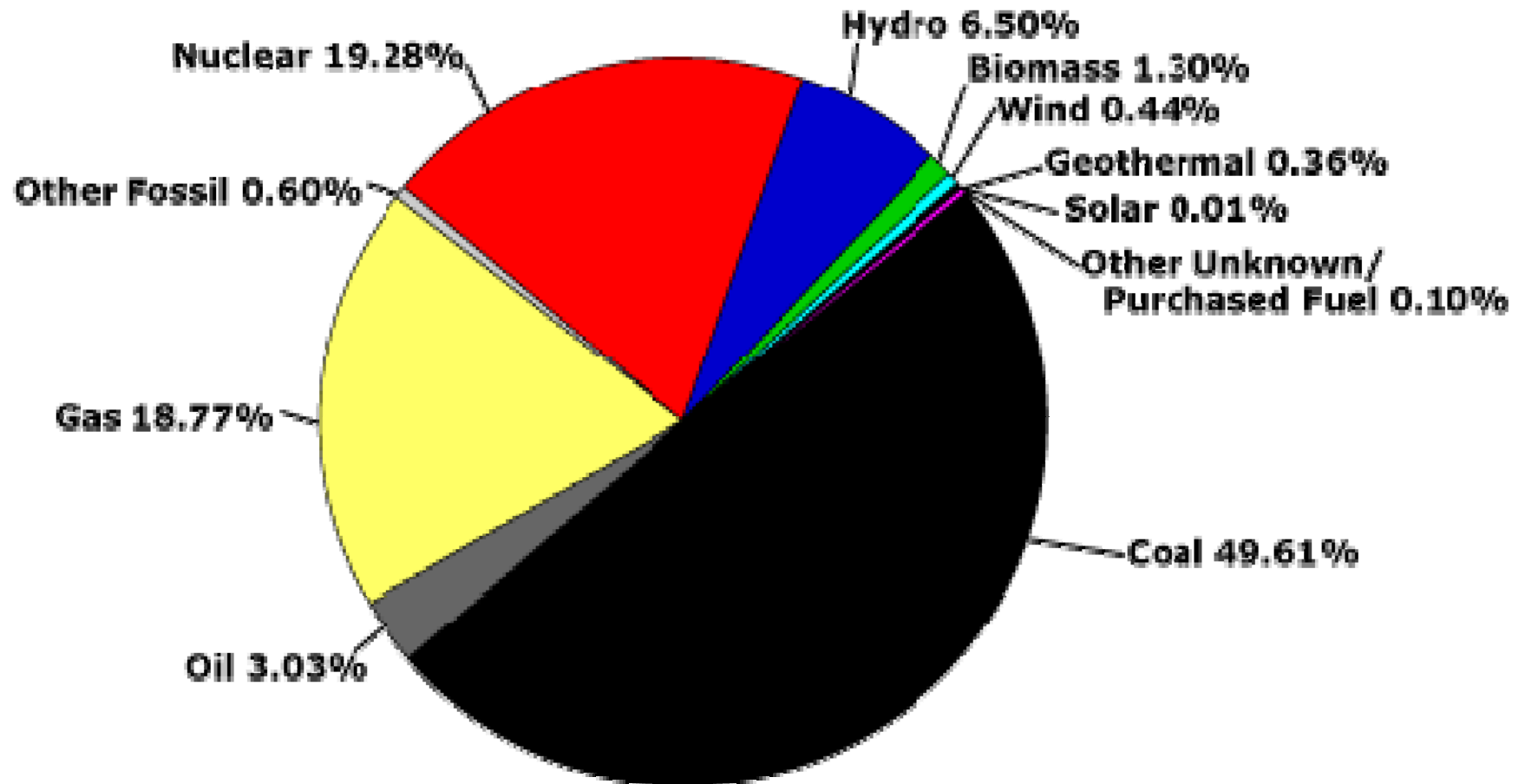
- » Federal

- » State

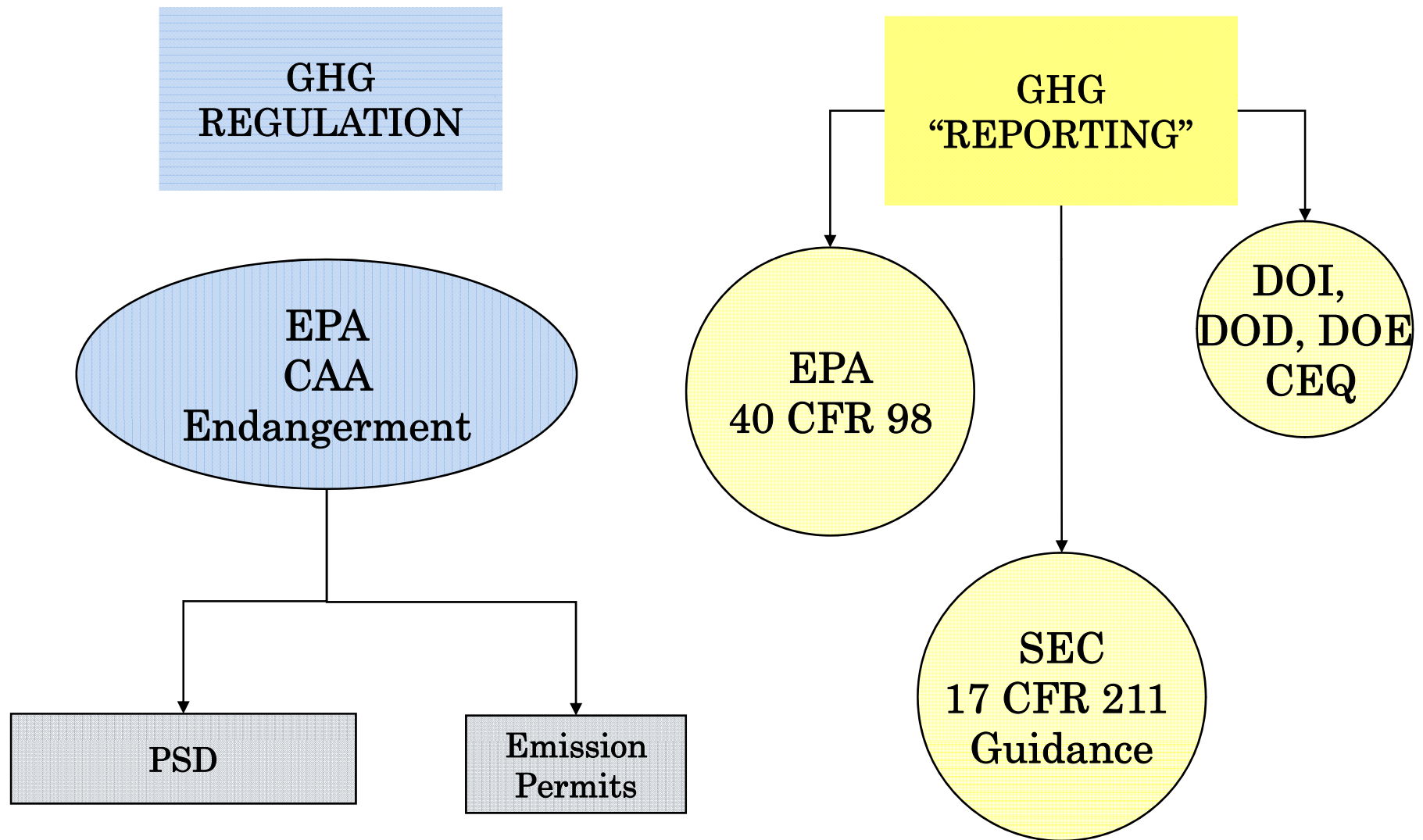
- » International

■ Risk Assessment – The Scope Of Due Diligence

Current Energy Mix (EPA)



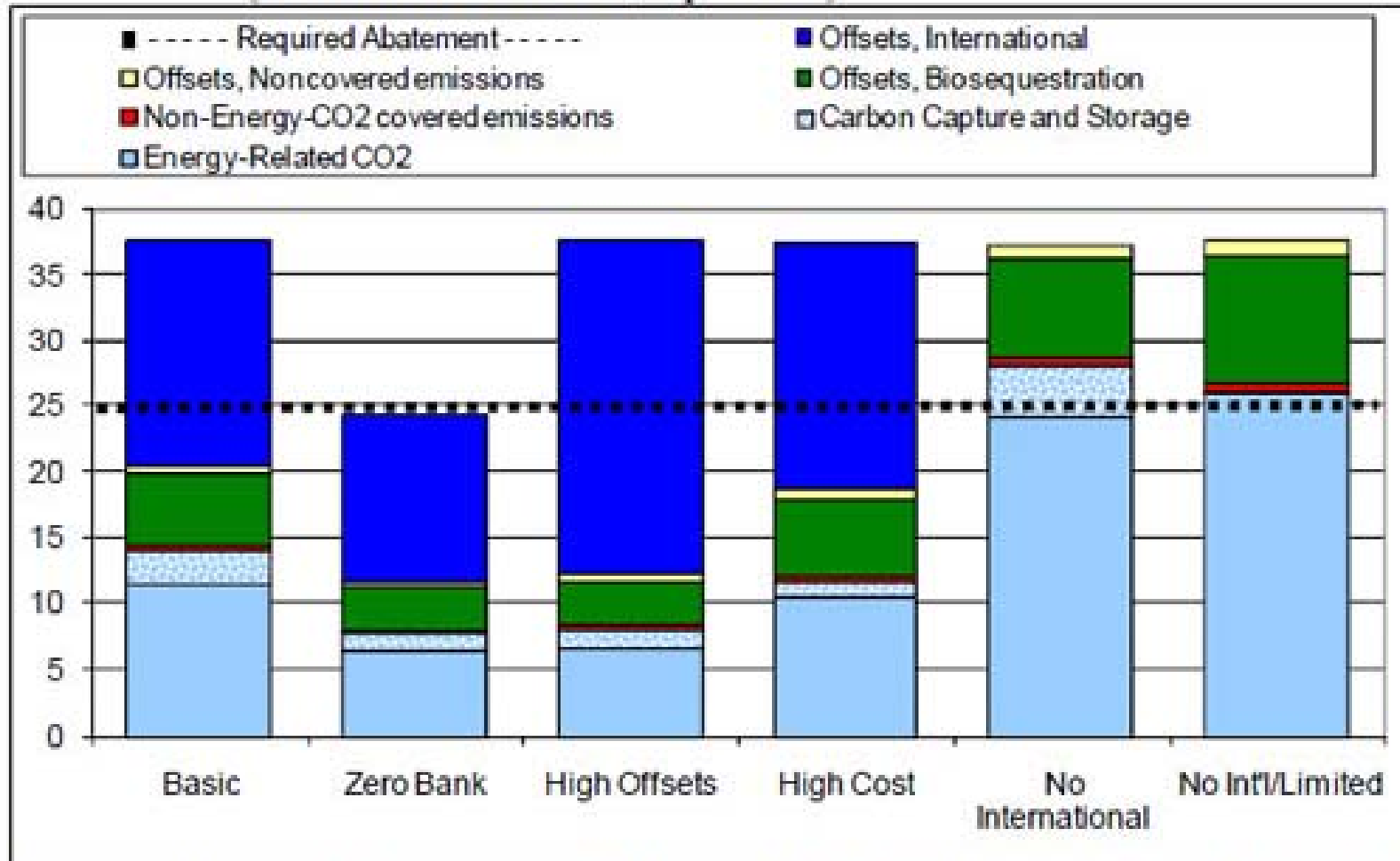
Legal Framework – The Federal Overview



Political Baseline

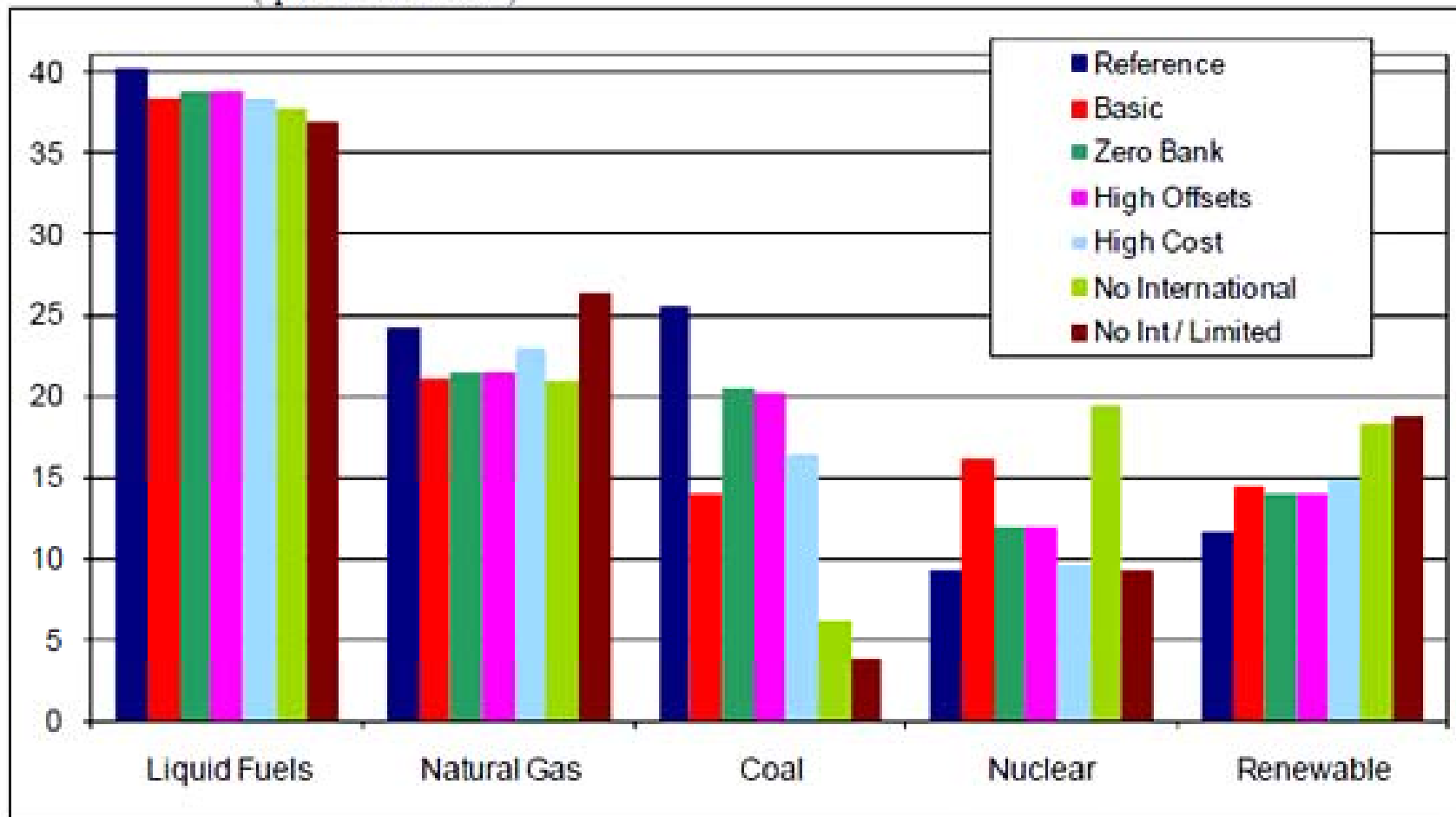
- **Obama Campaign: Economy-wide Cap And Trade, 100% Of Emissions “Allowances” Subject To Auction.**
- **Activist EPA.**
- **Waxman-Markey: Economy-wide Cap And Trade, Allowances Given To Preferred Constituencies.**
 - » 600 +/- pages of mandates.
 - » 800 +/- pages of cap and trade.

Figure ES-1. Components of Cumulative Compliance in ACESA Main Cases, 2012-2030
(billion metric tons CO₂-equivalent)



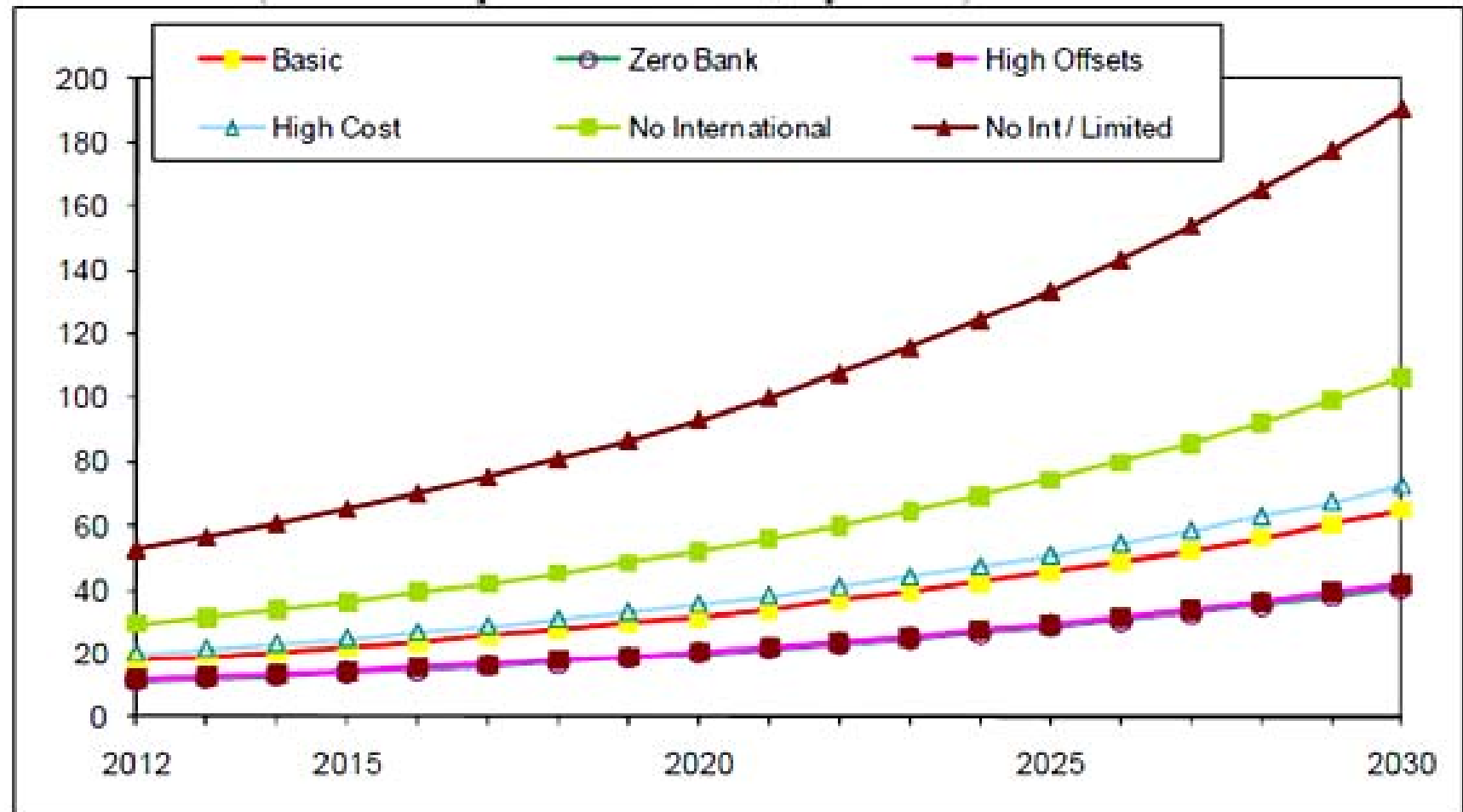
Source: National Energy Modeling System runs, STIMULUS.D041409A, HR2454CAP.D072909A, HR2454NOBNK.D072909A, HR2454HIOFF.D072909A, HR2454HC.D072909A, HR2454NOINT.D072909A, and HR2454NIBIV.D072909A.

Figure ES-2. Primary Energy Consumption by Fuel in Main ACESA Cases, 2030
(quadrillion Btu)



Source: National Energy Modeling System runs, STIMULUS.D041409A, HR2454CAP.D072909A, HR2454NOBNK.D072909A, HR2454HIOFF.D072909A, HR2454HC.D072909A, HR2454NOINT.D072909A, and HR2454NIBIV.D072909A.

Figure ES-3. Allowance Prices in Main ACESA Cases, 2012-2030
(2007 dollars per metric ton CO₂-equivalent)



Source: National Energy Modeling System runs, STIMULUS.D041409A, HR2454CAP.D072909A, HR2454NOBNK.D072909A, HR2454HIOFF.D072909A, HR2454HC.D072909A, HR2454NOINT.D072909A, and HR2454NIBIV.D072909A.

Expected Costs

- **Carbon Costs Will Hit All Sectors. Utilities And Transportation Have The Greatest Exposure.**
- **Basic Resources, Which Includes Steel And Aluminum Processing, Mining, Chemicals, And Heavy Manufacturing, Are Also At Risk.**
- **Large Commercial Developments Are At Risk.**
- **Costs Will “Pass Through” Via Higher Prices, Lower Production, Lower Employment.**

Senate State of Play

- **The American Clean Energy And Security Act (ACESA, Waxman-Markey, HR 2454) Likely Will Not Pass The U.S. Senate In Its Current Form.**

- **Kerry-Graham-Lieberman (KAL) Compromise.**
 - » No/Limited “cap and trade”
 - » No/Limited “preemption”
 - » More money for nuclear power
 - » Enhanced government command and control over energy production/consumption

State Law Framework

■ State Programs Add Duties.

- » Additional planning and reduction requirements.
6 NE states - 10% below 1990 levels by 2020, 75% below eventually (now assumed 2050), WCI (Western states) - 15% below 2005 by 2020
- » Regional trading systems (RGGI, WCI)
- » Other energy regulation (renewable requirements, efficiency demands, taxes)

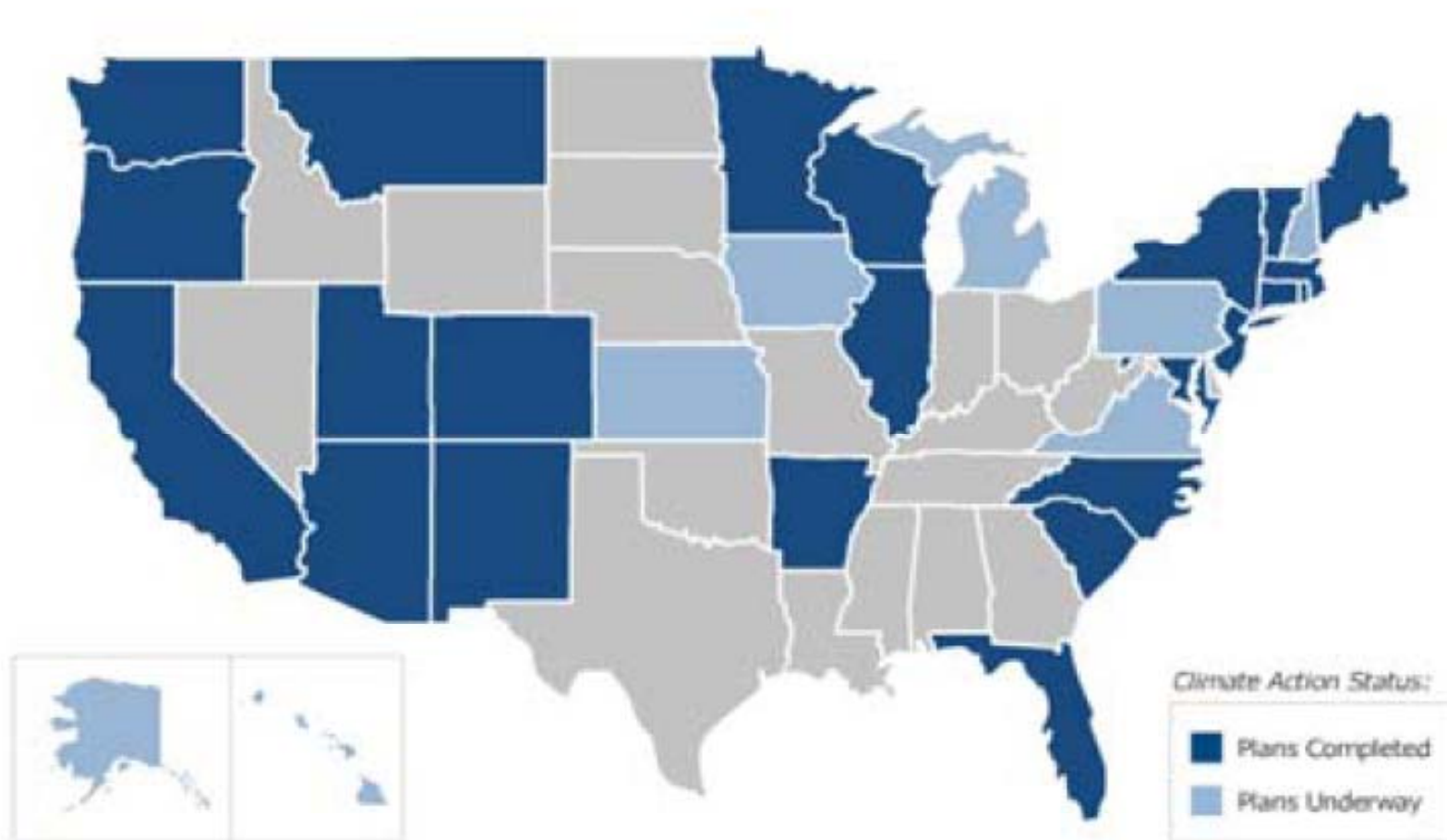
■ California Requirements Are The Gold Standard For Regulatory Intrusion.

EPA

- **Extremely Aggressive Regulatory Agenda.**
- **EPA's September 22, 2009 Final Rule for the Mandatory Reporting of GHGs.**
- **EPA also announced a final rule on March 29, 2010 that will phase in GHG emissions control requirements for new and modified stationary sources starting Jan. 2, 2011**

State Law Framework

Figure 1. States with Climate Action Plans Completed or Underway



International Requirements

- No “Cross-Border” Requirements.
- Substantial EU GHG Regulations (ETS).
 - » Regulations pushing manufacturing off-shore?

Summary

- **Extremely Fluid US Politics.**
- **Highly Dynamic Regulatory Environment.**
- **Extremely Uncertain Legal Environment.**

What Is To Be Done?



What Do We Know?

- **US: Mandatory Reporting/Mandatory Disclosure.**
 - » Compliance with environmental law now requires many (most?) companies to monitor and report GHG emissions.
 - » When PSD is applied (Jan. 2011) many companies will have new and onerous compliance requirements.
- **Energy Costs Will Increase, Supply May Decrease.**
- **GHG Risk Is Extremely Idiosyncratic.**

Corporate Risk Assessment/Due Diligence

■ How To:

- » Think about risk.
- » Assess compliance duties.
- » Calculate exposure.
- » Develop mitigation strategies.

Thinking About Corporate Risk

■ Financial Risk.

» Exacerbated by legal uncertainty.

■ Operational Risk.

» Supply chain impacts.

■ Reputational Risk.

Compliance Duties

■ Evaluate EPA/SEC/State Compliance Duties.

- » EPA Compliance: (1) Reporting duties (RTR – 40 CFR 98 et seq., approximately 45 subparts divided by industry sector, (2) Permit requirements (Tailoring Rule > 25k CO₂?)
- » SEC Compliance: Reg S-K Items 101, 103, 503(c) and 303 all potentially implicated. Note new ASTM Reporting Standard E2718-10.
- » State Laws: It depends.

Calculate Exposure

- **Winners/Losers**
- **Best/Likely/Worst Case**
- **Supply Chain Analysis**

Mitigation Strategies

■ What Can Be Done?

- » Process improvements.
- » Political improvements.
- » Off-shore.
- » Insurance/liability transfer.

Morgan Lewis

Environmental Warranties for Carbon Emissions

*Best practices for disclosures, warranties and
other risk protection measures*



Troy Brown

April 8, 2010

IMPLICATIONS OF NEW EPA REGULATIONS ON DRAFTING ENVIRONMENTAL INDEMNITY AGREEMENTS

- Regulations/Policies that Will be Addressed:
 1. EPA's September 22, 2009 Final Rule for the Mandatory Reporting of Greenhouse Gases ("GHGs")
 2. EPA's April 11, 2000 policy on "Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations"
 3. EPA's August 1, 2008, "Interim Approach to Applying the Audit Policy to New Owners ("Interim Approach")"

IMPLICATIONS OF NEW EPA REGULATIONS ON DRAFTING ENVIRONMENTAL INDEMNITY AGREEMENTS

EPA Regulations

1. Massachusetts v. EPA, Case No. 05-1120, April 2, 2007 (549 U.S. 497)
2. EPA's September 22, 2009 Final Rule for the Mandatory Reporting of GHGs
3. EPA also announced a final rule on March 29, 2010 that will phase in GHG emissions control requirements for new and modified stationary sources starting Jan. 2, 2011

Congressional Scheme

1. Speculation over whether Congress will implement a future cap and trade scheme
 - *GHG reduction credits (offsets) / allowances could be sold and traded in connection with acquisitions and independently*
 - *Specific representations and warranties will be required, including compliance with GHG allowance requirements, beneficial ownership, verifiability and permanence of reduction credits, reduction credits are free of encumbrances, etc...*

IMPLICATIONS OF NEW EPA REGULATIONS ON DRAFTING ENVIRONMENTAL INDEMNITY AGREEMENTS

- Traditional Environmental Representation and Warranty:
 - Seller represents and warrants that it is in compliance with Environmental Laws
- New Considerations Arising from GHG Regulations
 - Compliance with environmental law now requires that seller accurately monitors and reports GHG emissions
 - When PSD and Title V scheme implemented, representation will require that seller is in compliance with PSD and Title V requirements for GHGs
 - If cap and trade scheme implemented, additional representations and warranties will be required
 - *Beneficial ownership of reduction credits, reduction credits meet regulatory requirements and are free of encumbrances, etc...*

IMPLICATIONS OF AUDIT POLICIES ON DRAFTING ENVIRONMENTAL INDEMNITY AGREEMENTS

2. EPA's April 11, 2000 policy on "Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations" offers reduced penalties to companies that:
 - *Self-police environmental compliance at their facilities,*
 - *Promptly disclose and correct violations discovered, and*
 - *Take steps to prevent future violations.*

3. EPA's August 1, 2008, "Interim Approach to Applying the Audit Policy to New Owners ("Interim Approach")"
 - *Tailors Audit Policy incentives for new owners that want to make a "clean start" at their recently acquired facilities by addressing environmental noncompliance that began prior to acquisition*

IMPLICATIONS OF AUDIT POLICIES ON DRAFTING ENVIRONMENTAL INDEMNITY AGREEMENTS

- Considerations Arising from EPA's Audit Policies
 - Buyers seek to avail themselves of Audit Policy incentives
 - Under the policies, this is done by voluntarily disclosing environmental non-compliance
 - After making such disclosures, buyers then seek indemnity from sellers
- Important to consider implications of this in due diligence and while negotiating environmental indemnity provisions, particularly in light of EPA's Interim Approach

Environmental Due Diligence Considerations

- Due Diligence / Knowledge Waiver by Buyer
 - Buyer cannot seek post-closing indemnification for matters that were fully disclosed in due diligence
 1. *“As Is Waiver”*: provides that anything fully disclosed cannot serve as the basis for post-closing claims;
 2. *“Knowledge Based Waiver”*: narrows the scope of the waiver to matters known by a certain defined control group
 - Careful process must be established to prove disclosures were made during due diligence

Environmental Due Diligence Considerations

- Scope of Due Diligence
- Phases of Due Diligence
 - Phase I
 - Phase II
- Identification of Potential Noncompliance
- Documentation of Potential Noncompliance
 - Schedules Identifying Potential Noncompliance

Seller Protective Provisions

- Triggers for Buyer's Ability to Bring Claim Against Seller
 - Third Party Claim v. Buyer's Own Discovery
 - "No Dig" or "No Look" Clauses
 - Prompt and Sufficient Notice Requirements
 - Seller's Control of Remediation of Potential Non-Compliance
 - Seller's Control over Negotiations with the Government
 - Seller's Control over litigation with third parties
 - Buyer may only step in if Seller interferes with Buyer's operations
- Time Limits for Bringing Claims
- Indemnity Baskets and Caps

Buyer Protective Provisions

- No Due Diligence Based Waiver
 - Buyer is entitled to indemnity for violations without regard to whether they were discovered in due diligence
- Standard for Triggering Defense and/or Indemnity Obligations
 - No third party claim required
 - Standard for recovery should be clearly articulated

Buyer Protective Provisions

- Loose articulation of notice and control requirements
 - Buyer's Control of Remediation of Potential Non-Compliance
 - Buyer's Control over Negotiations with the Government
 - Buyer's Control over litigation with third parties
 - When can Seller step back in (if at all)?
- Consider cure period for breach of representation and warranty
- No Basket or Caps
- Survival of Representations and Warranties

CONCLUSIONS

- Change and Uncertainty in EPA Regulations and Policies, including those addressing GHGs
- Attorneys representing companies in mergers and acquisitions need to monitor these rule changes
- Protective contractual language, for buyers and sellers, is available and should be negotiated