Environmental liability is increasingly important in business valuations

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Environmental liability is an issue that arises in many business valuations, in particular, where the subject company handles or is exposed to hazardous or potentially hazardous substances.

Depending on the circumstances, both known and contingent environmental liabilities may materially affect the fair market value of the shares or net assets of the company subject to the valuation.

Generally speaking, environmental liability comprises two separate aspects:

(1) regulatory liability arising from the violation of government rules and regulations, and

(2) civil liability that results from a lawsuit initiated by person claiming to have been harmed as a result of one or more common-law causes of action allegedly caused by some other party.

In Canada, the most comprehensive piece of federal legislation related to the environment is the *Canadian Environmental Protection Act, 1999* (CEPA). Enacted in 1985 and significantly revised in 1999, this Act consolidated and repealed a number of earlier statutes.

CEPA establishes controls over the release, use and elimination of certain regulated substances that can affect air, land, and water; controls the use of substances that are thought to deplete the ozone layer; imposes requirements on the registration and use of new chemicals, substances and genetically modified or designer organisms; and has introduced the concept of pollution prevention programs.

In addition to federal environmental regulation, all of the provinces and territories have complimentary environmental laws. Provincial and territorial environmental laws and regulations govern various activities that affect human health and

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the environment within each jurisdiction.

The third layer of environmental regulation lies at the municipal level. In general, municipalities have powers to enact bylaws to regulate the release or discharge of process effluents and industrial waste into the sewer system, but it appears that this scope can be broadened.

Environmental liabilities generally are difficult to quantify with any degree of certainty. In open-market transactions, environmental liabilities often are dealt with through provisions that assign, exclude or allocate liabilities between the parties. In notional-market valuations, it typically is not the case that environmental liabilities can be dealt with in the same manner as in open-market transactions. In notional market valuations, two options exist:

- attempt to reasonably quantify the environmental liability based on available evidence; or
- in the absence of adequate evidence to assist in quantifying the alleged environmental liability, any valuation conclusion should be qualified.

An environmental liability can fall into one of the following categories:

- a known environmental liability — that is a legal or regulatory compliance obligation of the subject company to incur a one-time or ongoing future expenditure(s) due to the past or ongoing manufacture, use, emission, release, or threatened release of a particular substance, or other activities, that may impair or adversely affect human health or the environment (referred to herein as "Environmental Activities");
- a planned environmental liability — in certain circumstances, a company may not face a legal or regulatory obligation but may choose, for "public policy" or other reasons, to incur a one-time or ongoing future expenditure(s) due to Environmental Activities; or
- a contingent environmental liability — that is a potential legal obligation to incur a one-time or ongoing future expenditure(s) due to Environmental Activities.

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Environmental liabilities vary with both the nature and timing of the cost. Examples of one-time costs might include:

- initial capital outlays and expenditures needed to clean up contamination; and
- initial capital outlays and associated expenditures needed to comply with current environmental laws.

Examples of ongoing costs might include:

- additional operating costs resulting from capital outlays;
- foregone revenues resulting from the forced curtailment of operations; and
- additional operating costs resulting from required changes to the subject company's waste disposal practices.

Environmental liabilities include:

- compliance obligations related to laws and regulations that apply to the manufacture, use, handling, disposal and release of chemical or other hazardous or toxic substances and to other activities that may impair or adversely affect human health or the environment.

In this regard, whether the subject company was in compliance with existing laws and regulations at the valuation date should be considered, along with the possibility that new laws and regulations will be enacted that the company may, at least initially, be in a difficult position to comply with.

If it is discovered that the subject company is not in compliance, the expected costs of achieving compliance should be assessed.

A newer trend among certain regulators is to require financial security from a company to guarantee certain regulatory obligations (*e.g.*, closure costs).

- remediation obligations incurred to bring the condition of contaminated property into compliance with existing laws, regulations, or in some cases, commercially accepted remediation guidelines that have been accepted by business as an appropriate standard;
- obligations to pay fines and penalties for non-compliance;
- obligations to compensate private parties for damages in respect of personal injury, property damage, and economic loss;
- obligations to pay punitive damages for grossly negligent conduct; and
- other environmental-related obligations, such as ethically motivated environmental expenditures.

Quantification considerations

Once it has been established that either known or contingent environmental liabilities exist,

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it typically is necessary to attempt to reasonably quantify them. There are two basic approaches to do so.

First, the discount rate applied to projected discretionary after-tax cash flows can be increased to reflect the increased risk that the identified environmental liability may negatively affect future cash flows.

The second method is to attempt to calculate the present value of the after-tax future environmental costs and to adjust the fair market value otherwise determined by this amount.

When quantifying environmental liabilities, consideration generally should be given to:

- the likely quantum and timing of anticipated prospective after-tax environmental related costs;
- the probability of the environmental liability materializing and the cost thereof where the liability is contingent on a future event; and
- possible recourse by the subject company against third parties.

Conclusion

As society's attention continues to focus on the health of the environment, environmental liability issues likely will continue to surface with greater regularity.

As a result, environmental liabilities likely will continue to come under greater scrutiny in both notional-market and open-market transactions.

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