Recent Developments Impacting Environmental Due Diligence in M&A Transactions

Company A's CEO has just informed his general counsel (GC) that the company will be selling off some under performing facilities in various states. It's not yet clear whether the transaction will proceed as a stock purchase, an asset purchase, or a straight real estate sale. In addition to structuring and overseeing the transaction itself, the CEO further instructed his GC to organize and direct the company's environmental due diligence efforts. Where should Company A's GC begin? The first thing to do is to understand exactly how the deal itself will be structured. Will it be a straightforward sale of real properties, or the sale of income-generating operating assets, or the sale of stock? The answer to this question, in turn, will indicate what type of environmental due diligence will be needed.

By contrast, the GC representing the likely purchaser, Company B, has a completely different set of questions, priorities, and concerns. What she will need during the course of due diligence and the ensuing negotiations will also depend upon the nature of the deal. The purpose of this article is to offer a practical framework to address these issues, from both a seller's and a purchaser's perspective.

By Vincent M. Gonzales, Brian E. Heim, Rose M. Murphy, Amy L. Edwards, Jennifer L. Hernandez, and Bonni F. Kaufman

OR NO DEAL

It should come as no surprise to most in-house counsel that environmental issues are frequently material in any kind of M&A transaction, particularly with respect to asset valuation and the disposition of past and future environmental liability and risk. The job of the general counsel is to identify the possible risks and liabilities so that he or she can find a transactional solution to these issues in order to ensure deal success. What is less obvious is that the environmental due diligence process itself can trigger other concerns for the seller, particularly if it is publicly traded. For example, if the seller learns about areas of non-compliance or unanticipated cleanup costs that are necessary, it may need to amend its financial disclosures in its 10Ks, 10Qs, and annual reports in order to satisfy evolving requirements under Sarbanes Oxley and FIN 47.

The rules governing environmental due diligence have recently changed. Many purchasers will now require compliance with EPA's Final All Appropriate Inquiries Rule (AAI), 40 CFR Part 312, which governs the acquisition of commercial real estate. This rule went into effect on November 1, 2006. Other due diligence standards may be more appropriate for other types of transactions. Purchasers might also seek greater price concessions for known environmental conditions because of the greater difficulty in recouping "voluntary" cleanup costs in light of the Supreme Court's decision in *Cooper Industries, Inc. v. Aviall Services, Inc.*, 543 U.S. 157, in December 2004. Finally, a purchaser will be using the environmental due diligence process to ascertain what regulatory conditions or constraints, if any, exist that may limit or even prohibit its intended use of the target company and its assets. Typical constraints could include permit limits, wetlands, or endangered species on the target's property. We will discuss each of these issues in greater depth.

VINCENT M. GONZALES is senior environmental counsel for Sempra Energy in its Los Angeles office. He currently chairs ACC's Environmental, Health, and Safety Committee. He can be reached at *vgonzales@sempra.com.*

BRIAN E. HEIM is senior counsel, environment, health and safety, with International Paper Company in Memphis, TN. He can be reached at *brian.heim@ipaper.com.*

ROSE M. MURPHY is vice president, corporate secretary, and associate general counsel of Masonite International Inc., based in Tampa. Previously, she held multiple positions with International Paper Company. She started her carrier in Dallas practicing as a commercial litigator. She can be reached at *rmurphy@masonite.com.*

AMY L. EDWARDS is a partner at Holland & Knight where she cochairs the firm's National Environment Team. She was an advisor to the NCCUSL when it developed the model Uniform Environmental Covenants Act and is also a member of the advisory board to BNA's *Environmental Due Diligence Guide.* She can be reached at *amy.edwards@hklaw.com.*

JENNIFER L. HERNANDEZ cochairs Holland & Knight's Environmental Team. She is ranked as one of the top 500 lawyers in the country by LawDragon, as one of California's top 10 environmental lawyers in the Chambers USA Guide to the Top Business Lawyers in America, and as one of Northern California's top 100 lawyers and top 50 women lawyers by Superlawyer. She can be reached at *jennifer.hernandez@hklaw.com.*

BONNI F. KAUFMAN is senior counsel in the Public Policy and Regulation Group of Holland & Knight LLP, where she focuses on the practice of environmental law. She can be reached at *bonni.kaufman@hklaw.com.*

Purpose and Scope of Environmental Due Diligence

The primary purpose of the environmental due diligence process is to identify material environmental conditions, risks and constraints, such as legacy liabilities, operational or ongoing liabilities, areas of non-compliance, and potential constraints upon facility expansion or modification.

One of the first things that the two GCs need to address is the likely structure of the deal. Whether the transaction is structured as an asset sale, stock sale, or traditional sale of real estate will dictate what type of environmental due diligence is appropriate. Other preliminary considerations include confidentiality concerns and financial disclosure issues.

Asset Purchase

If the transaction is structured as an asset purchase and sale, Company B may have a greater ability to insulate itself contractually from Company A's environmental liabilities. The primary exceptions to this rule include a de facto merger or consolidation, a "continuation of the enterprise," a situation where Company B expressly assumes Company A's environmental liabilities, or a fraudulent transfer. If Company B is able to insulate itself from Company A's liabilities, it is not going to need to press as hard to discover what all of those liabilities may be. However, Company B should consider the financial strength of Company A after the sale. An indemnity is only as good as the solvency of the indemnitor.

As a practical matter, it is important not to be too confident in the law as it currently exists. Not only does the law change frequently in this area, but the changes can sometimes be very radical or unexpected. The *Cooper v. Aviall* case, in particular, is forcing many courts to rethink their approaches to contribution claims, even after having established decades of jurisprudence on the subject. Even if the current law favors the fact that liability will be retained by Company A, Company B should still expressly provide in the agreement that Company A retains all responsibility for claims arising from or related to any event or condition present or occurring prior to the sale, including, but not limited to, environmental conditions, expo-

sures, or releases. Moreover, Company B should obtain an indemnity from Company A. Many long tail exposures (such as asbestos and various cancers) surface decades after the sale and the laws either could change or, based on public policy, another state's laws could apply.

Stock Purchase

In a typical stock purchase transaction, the purchaser is stepping into the shoes of the seller and thereby assuming all of the seller's liabilities. For this reason, in a stock transaction, Company B would have a vested interest in knowing as much as it can about the full scope and extent of Company A's existing environmental liabilities and any potential constraints upon facility expansion or modification. An informed purchaser is likely to insist upon a type of due diligence that goes beyond AAI. Alternative standards for this type of transaction include the ISO 14015 standard, "Environmental Management—Environmental Assessment of Sites and Organizations" or an alternative standard that is under development and currently titled, "Diligence Alternatives for Transactional Assessments" (the DATA Standard). Often, the seller is spinning off a wholly-owned subsidiary. Where the seller is a well funded "parent," there is a much greater opportunity to contractually obligate the seller to retain some or even all the environmental liabilities of its former subsidiary.

After full due diligence, the agreements should specifically reflect retained and transferred liabilities, the cleanup standards and procedures for any cleanup. Often current acceptable standards of exposure based on known science are modified in future years or things are missed. Company B should attempt to draft a provision that:

- is not restricted to existing laws but, rather, any environmental condition, release or exposure occurring before the sale;
- leaves the length of time to bring a claim open; and
- does not cap Company A's economic responsibility to remediate and pay for claims.

Company A would want the opposite: a limitation of its retained liabilities to current environmental laws, a limitation on the length of time of any retained liability, a cap on its total economic exposure and, if it can get it, a release and an indemnity from Company B for any exposures transferred to Company B above the caps or after the limitations period expires. One way to bridge this gap is to have both split the cost of environmental insurance to cover the cost of any future environmental liability, commencing after an agreed time period, say, 10 years after the closing date, during which period Company A bears all the risk of any legacy environmental liability.

Key Areas to Coordinate with the Transactional Negotiation Team

There are a number of other issues that should be coordinated between the transactional negotiation team and the environmental due diligence team to be sure that Company B is acquiring the information it needs to know as part of the due diligence process. These include:

1. Identification of any capital expenditures needed to meet new or renewed pollution control permits. There may be a need, for example, to upgrade existing pollution control equipment to meet new Clean Air Act regulatory limits that will become effective shortly. If inadequate reserves have been set aside for this upgrade, the plant may be unable to operate, or unable to operate at the throughputs currently specified in its permit. Company B should try to keep Company A liable for post-closing capital improvement upgrades in the event that the government brings an enforcement action and requires such upgrades based on pre-sale operations or violations.
2. Identification of any future costs to comply with global warming legislation and increases in energy spending. New legislation, particularly at the state level, may require operating facilities to report and reduce their CO_2 emissions and to obtain "credits" for these reductions. It behooves the transactional and environmental teams to discuss whether CO_2 emissions may be an issue in the transaction.
3. Identification of any future permitting issues for expanded operations, process modifications, or new facilities. If the facility intends to expand its current operations, or to build new ones, or to otherwise change its operations, it is important for the transactional and environmental due diligence teams to be talking about environmental issues that could adversely impact these plans, such as whether the facility is in a non-attainment area, whether the facility might encounter new source review (NSR) or prevention of significant deterioration (PSD) issues, and whether the watershed in which the facility operates has any total maximum daily load (TMDL) issues.
4. Identification of other project constraints, such as protected species and wetlands/surface waters. The presence of endangered species (or their habitat) or wetlands may adversely impact the company's ability to expand its existing facilities or to build new ones.

Other Due Diligence Do's and Don'ts

There are a number of other issues that in-house counsel should keep in mind when reviewing the environmental provisions in a corporate or real estate transaction:

1. Beware of using outdated boilerplate environmental language! The field of environmental law is constantly changing, so if your outside real estate or corporate counsel are using "boilerplate" environmental provisions that have not been reviewed by experienced environmental attorneys within the past year, they could be creating unnecessary ambiguity and vagueness in your contractual documents.
2. Identify employees who will be "going with the deal" and separate them from the negotiations if possible on the seller side and insure that you have access to them from the buyer side. This is a key consideration when the transaction is of the company itself, or of an operating asset, where the employees' understanding of the environmental requirements as well as overall institutional knowledge of the asset or the company, make them an important part of the deal.
3. Don't hide issues—Obfuscation of the issues will only damage your credibility and possibly delay the closing in the long run. Consider entering into a confidentiality agreement at the start of negotiations so that sensitive environmental issues can be disclosed and discussed candidly.
4. Be prepared to make the tough decision as an in-house lawyer to advise your company's management not to go forward with a particular deal. Outside counsel can provide the legal pros and cons, and environmental consultants can provide all of the relevant data points and technical analyses you need, but neither of them are in the position to determine which risk levels are acceptable to the company. An in-house lawyer's client is the company as a whole, and not its individual parts or departments. Hence, even if one part of the company views a given transaction favorably, if in-house counsel's environmental due diligence efforts have led to the conclusion that the deal may not be in the best interest of the company as a whole or in the long term, then it is his or her professional duty to say so.
5. Assist in setting appropriate environmental reserves and verify that they will survive closing. You will also need both your business person and your risk management expert to help you.
6. Be mindful of whom you represent—the seller or the purchaser—lest you do the other party's due diligence duty instead of your own. In our example, Company A must disclose what it knows about the environmental condition of the property to Company B who then must process that information and assess the property in light of what it wants to use it for—a datum that Company A is not likely to know or understand fully. For example, a purchaser who owns and operates, say, day-care facilities is in a better position of evaluating the environmental risks of purchasing a property for its specific uses, compared to a seller of a former service station who is disclosing the site's environmental conditions to the purchaser and is not likely to understand such an operation as much as the purchaser.
7. Be mindful of the fact that, if the purchaser is planning to use outside financing to fund the acquisition, the purchaser's lender is likely to have its own environmental due diligence requirements. Many (but not all) lenders are requiring their borrowers to follow the new AAI rule. They frequently are unwilling to fund an acquisition unless a No Further Action letter (or equivalent) has been issued by a federal or state environmental agency for a known environmental condition on the site, or at least know what type of process the purchaser intends to follow to resolve the environmental concern. In our example, if the environmental condition is significant, the lender is also likely to demand an environmental indemnity and perhaps an environmental escrow from Company B. Company B will be conducting its negotiations with Company A with these considerations in mind.
8. Finally, if you are purchasing an asset as an ongoing concern, with the intent to continue operating it as such, then do not forget to include in your environmental due diligence plan, the careful review of the asset's environmental permits, plans and approvals, such as air quality operating permits, wastewater discharge permits, spill prevention, containment, and contingency plans. Permit conditions, in particular, need to be closely scrutinized to ensure that they do not include limits or restrictions that you are not prepared to accept. Do cast a very critical eye when these permits are later reissued with Company B's name, because permitting agencies can sometimes revise permit conditions without informing the purchaser accordingly.

How the other issues are resolved depends in large part on which party has a greater stake in having the deal succeed; that party is more likely to make compromises in the end. The parties should also address who will be responsible for remediation and the cleanup standard. Company B will control the facility and will want a zero detection standard. Company A will have the economic exposure and will want to limit the remediation to the minimum legal standard in place at the time of the sale with maybe a deductible or threshold that needs to be reached before and a total cap. Since Company B will, in the end, be in possession of the property, another approach to consider would be for Company A to fund a trust account dedicated solely to the remediation of the property which Company B will be responsible for managing. This, in turn, will incentivize Company B to be prudent in its choice of cleanup levels and ongoing monitoring methods, in order to make the trust fund last as long as it can. Regardless of how this issue is resolved, it should be negotiated and understood from the beginning to avoid litigation and hostility when claims surface years later.

Commercial Real Estate Acquisition

Where commercial real estate is being purchased, Company B is likely to insist upon conducting its own environmental due diligence in accordance with EPA's final AAI rule or the current version of the ASTM Standard for Environmental Site Assessments: The Phase I Environmental Site Assessment Process (E 1527-05), in order to qualify for one of the Landowner Liability Protections (LLPs) that was created as part of the Brownfields Amendments of 2002. Notwithstanding the AAI rule, a judge or jury might still hold a "sophisticated" buyer to a higher due diligence standard than AAI. Most large corporations, as well as companies that routinely buy and sell commercial or industrial real estate, would likely to be considered "sophisticated" buyers by a court, whereas a "Mom and Pop" tenant might not.

Confidentiality Issues

The transaction may proceed in a two step process if the parties have agreed on the need to keep the proposed transaction confidential. For example, during the first step, the general counsel of Company A may not want its employees,

Seller's Due Diligence Checklist

1. Objective is to sell property "as-is" with full releases and indemnification from the Purchaser with minimal impact upon price.
   - Limited or no environmental reps and warranties and indemnities;
   - Broad releases from the purchaser;
   - Control type and timing of cleanup;
   - Make Purchaser responsible for any change in use of the property; prohibit certain uses on the site (e.g. day care centers, residences, schools, parks); and
   - Place a total economic cap on any claim arising from the agreement.

Buyer's Due Diligence Checklist

1. Objective is to purchase property without any responsibility for pre-existing environmental contamination and conduct due diligence with any expansion plans for the facility in mind.
   - Broad environmental representations and warranties and indemnities from Seller;
   - Escrows or purchase price reduction to address known environmental conditions;
   - Ability to control type and timing of cleanup;
   - Ability to conduct a Phase I ESA;
   - Determine whether Phase II ESA will be needed/allowed; and
   - Determine whether environmental insurance is warranted and, if so, if it is available and at what cost.

Type of Due Diligence That Should be Conducted

1. Real Estate Acquisition Due Diligence—Phase I ESAs
   - E 1527-05
   - Purchaser needs to be named or obtain reliance letter
2. Regulatory Compliance Due Diligence
   - ASTM E 2107-00
   - EPA's Audit Policies
3. EMS Due Diligence—ISO 14015 Environmental Management—Environmental Assessment of Sites and Organizations (EASO)
4. Diligence Alternatives for Transactional Assessments (DATA Standard)

ACC Extras on…Environmental Due Diligence

2007 ACC Annual Meeting

204 What Litigators Know About Transactions that M&A Lawyers Should Know Too. How would you like to have open time with your litigation peers who will share their 20/20 hindsight on the M&A deal and what M&A practitioners should know about how your contracts get interpreted? You can if you register now for this session at ACC's 2007 Annual Meeting, October 29-31, in Chicago. Visit our website at *am.acc.com* for more information.

ACC Annual Meeting Program Materials

*Corporate Governance Issues in M&A Transactions (*2006). This program material is your chance to learn the law you need to intelligently advise your management and board. It reviews corporate governance issues and responses through all stages of an M&A transaction including planning, due diligence, negotiation, board liability issues, the board approval process, and the shareholder approval process and send you home with the resources you need to counsel your client. *www.acc.com/resource/v8202*

ACC Quick Reference

Due diligence checklist (2007). This due diligence checklist should be used in evaluating the acquisition of a company. *www.acc.com/resource/v7418*

InfoPAKs

Preparing for and Responding to an Accidental Environmental Release: A Legal Primer (2005). This InfoPAK seeks to provide in-house counsel with information on planning for, responding to, and investigating the causes of accidental releases of hazardous substances to the environment. *www.acc.com/resource/v5277*

Metropolitan Corporate Counsel (MCCA)

Merger & Acquisition Practice in China (December 2006). This article provides an overview of the laws regarding mergers and acquisitions in China. *www.acc.com/resource/v8018*

Sample Forms

- *Memo: Process for Dissolving a Delaware Corporation (2006). www.acc.com/resource/v6680*
- *Merger Notification and Procedures Template* (2006). This template is intended to provide initial background on the jurisdiction's merger notification and review procedures. *www.acc.com/resource/v7673*
- *Term Sheet* (2006). This term sheet lists structure, purchase price, and other conditions to consider in M&A transactions. *www.acc.com/resource/v7699*

Webcasts

- "Deal or No Deal: Recent Developments Impacting Environmental Due Diligence in M&A Transactions" (2006). The authors provide an update on some of the legal requirements that have changed, and provide some practical tips on how to conduct environmental due diligence quickly and efficiently. The attorneys who presented this program addressed:
- The purpose and scope of environmental due diligence; how those two issues will affect the process; and some practical tools;
- SEC environmental disclosure obligations;
- Methods for estimating environmental liabilities;
- New regulatory requirements for conducting environmental due diligence (AAI); and
- the legal protections that a company might enjoy if it conducts due diligence in accordance with these new standards.

  Transcript available at *www.acc.com/resource/v7574*.

- "Recent Developments in European M&A and Securities Law, and EU Privacy Law" (2006). This webcast discusses the effect of the EU Prospectus Directive on offerings of securities in the EU in connection with employee stockholding plans, the impact across Europe of the EU Takeover Directive, the growing appeal to US companies of the London Stock Exchange's AIM market, and the clash of EU privacy laws with SOX whistleblowing requirements. Whether your company is located in the EU, doing business there, or has listed (or is contemplating a listing of) securities on an EU exchange, our panel of experts will provide you with the most up-to-date information. *www.acc.com/resource/v7420*.

neighbors, tenants, or regulatory agencies to know that the company is being sold until the basic structure of the deal has been worked out with Company B. Why would this need for confidentiality be more compelling in a deal involving environmental issues, compared to a deal with no environmental issues? This is because any premature disclosure of the transaction, before both parties are ready, can cause problems in various environmental situations. For example, if one of Company A's properties being sold is the subject of a remediation effort funded by multiple PRPs (potentially responsible parties), then the premature disclosure of its impending sale could potentially disrupt cost allocation negotiations among the PRPs, especially if some PRPs feel that Company A will be unfairly receiving a "windfall" from the sale of a contaminated property that has now been cleaned up with help from other PRPs. Accordingly, a confidentiality agreement with Company B is a very important aspect of the deal at this stage. Once the basic deal structure has been determined, then Company B may be able to conduct something closer to an AAI type inquiry during the second phase of the deal.

Typical parties who should be included are the director of **environmental health** and safety; counsel; the business person; possibly the **plant manager;** an outside environmental consulting firm; and someone to serve as a **liaison** to the transaction negotiation team.

Disclosure Issues

Company A is likely to be very apprehensive about reporting and disclosure issues that could be triggered by Company B's due diligence process. Indeed, the kinds of environmental issues discovered through this process may very well trigger disclosure obligations under Sarbanes Oxley, FASBY, and FIN 47, in addition to state release reporting obligations, state transfer law requirements in various jurisdictions, and even employee right-to-know requirements. Furthermore, Company A's anxiety level is likely to rise even more if Company B can also change its mind and walk away from the deal as a result of such a process.

The filing of the purchase agreement should not be the first time that long-term environmental liabilities see the light of day. A public company had better have its environmental disclosure house in order before a major deal. At a minimum, Company A will want to control any governmental or financial disclosures that are required as a result of Company B's due diligence and should be able to oppose any consultant's conclusions. The agreement should restrict Company B's ability to discuss matters with environmental agencies without Company A's agreement and participation. Company B may need direct access to the local environmental agency, but should understand the sensitivity. A wrong communication could result in an investigation or could damage the current relationship between the seller and the agency.

The Environmental Due Diligence Process

The CEO has said the process needs to begin next week. The first question for Company A's general counsel is who should be part of the environmental due diligence team. Typical parties who should be included are the director of environmental health and safety; counsel; the business person; possibly the plant manager; an outside environmental consulting firm; and someone to serve as a liaison to the transaction negotiation team.

The next step is to identify which environmental reports should be furnished to prospective purchasers. Just those reports that the company has commissioned? All reports within its possession or control? How far back in time? Company A's GC has to consider how best to make this information available to prospective purchasers. Options include providing hard copies of the reports; burning copies onto a CD; creating a central repository of the reports; or using a secure website.

Another early consideration will be which individuals will be identified as "having knowledge" on behalf of Company A in the contractual documents, such as the purchase and sales agreement. The potential parties include senior officials only; the director of environmental health and safety; the plant manager or other plant personnel; and possibly former plant personnel. This individual (or individuals) will likely be listed as the person with knowledge of various conditions and compliance issues for purposes of the company's representations and warranties in the purchase and sale agreement and related schedules. If the purchaser will agree to a knowledge qualifier limited to certain people, it could potentially decrease future claims or litigation due diligence costs since the list of people will be limited.

As the transaction is being put together, Company A's GC

will also need to decide whether the purchaser will be given the option of selecting which of the operating facilities to purchase (an "opt in/opt out" choice). In some cases, allowing such a choice can play a key role in preventing a deal from crashing in light of the environmental issues being disclosed. The purchaser may also be concerned about formerly owned and operated facilities and disposal facilities previously used, particularly if the company had not previously divested itself of such legacy liabilities. Moreover, if the facility was purchased by the Company, the GC should ascertain whether there are indemnities or retained liabilities from the prior owner that could be transferred as part of the sale.

An area of increasing tension in transactions is whether the purchaser should have the ability to conduct intrusive sampling during due diligence. The purchaser is driven by the need to understand and quantify potential risks and costs and to understand the "continuing obligations" that it may assume upon purchasing the property. A purchaser will typically request 60 to 90 days in order to collect one or more rounds of intrusive samples. In our case, Company B may insist on such testing even if Company A provides Company B with prior analytical data about the environmental condition of the property, primarily because only Company B is in the best position to evaluate the property and determine its value to its business. For example, if Company B plans to construct a day-care facility on the property and Company A's prior environmental study has analyzed the property for every hazardous substance with the sole exception of lead, then Company B has no choice but to enter the property and test for lead, because lead, once ingested, can cause much more severe harm to a child than to an adult.

Of course, Company A would understandably push back against such an intrusive activity. Apart from the reporting and disclosure issues that such sampling would raise, this activity could also place an undue burden on Company A, particularly if the property is an operating facility with employees and critical process units. If no alternative presents itself, then the parties must carefully negotiate an access agreement that contains or addresses in full all of the important items, such as a detailed and comprehensive sampling plan that includes a site map with sampling points identified therein, a safety or hazard communication plan to ensure that no individuals or personal property are harmed or damaged during the sampling events, as well as a discussion of how the samples will be analyzed, for what constituents and by what labs. On the other hand, Company A may be able to avoid this by agreeing to purchase an environmental insurance policy for Company B, or to agree in the sales agreement to indemnify Company B for any loss with certain caps, deductibles and other restrictions. In the end, Company A may

The parties will **need to agree upon** what types of claims will **trigger** the indemnity, **how long** the indemnity agreement will remain in place, and the **process for raising a claim.**

conclude that it has no other choice but to allow Company B to conduct intrusive analytical sampling, because refusal will likely cause Company B either to adjust the purchase price downward to compensate for unknown environmental risk, or, worse, to walk away from the deal entirely.

Company B will also typically seek the right to interview and potentially negotiate with the regulatory agency in order to verify the scope of required cleanup activities and potentially negotiate an alternative arrangement for resolving any environmental conditions that may have been found (e.g., a state voluntary cleanup agreement or a Prospective Purchaser Agreement with EPA). This is another area of concern for Company A who understandably might object to such a request unless it received reasonable assurance that Company B is intent on completing the transaction and will not "walk away" and leave Company A in a worse position with respect to the government. As stated in the disclosure section above, at a minimum, Company A will want to control any governmental or financial disclosures that are required as a result of Company B's due diligence and should be able to oppose any consultant's conclusions.

Steps in the Environmental Due Diligence Process

If a recognized environmental condition exists, or is likely to be discovered during the environmental due diligence process, it is important to decide, from a business risk perspective, how the company wishes to deal with that environmental condition. Options that are commonly used include the following:

- An environmental escrow,
- An environmental indemnity agreement,
- Pollution Legal Liability Insurance,
- Cost Cap Insurance Policy or Guaranteed Fixed Price Remediation contract,
- A reduction in the purchase price, and
- A decision whether the seller, or the purchaser, will clean up the contamination, and whether the cleanup will occur pre- or post-closing.

Each of these tools has its own strengths and weak-

nesses. Environmental escrows are commonly established to deal with known environmental issues on a site. The parties will need to agree, in advance, upon the amount of money to be placed in escrow, the process for accessing those funds, how long the escrow will endure, and how to resolve disputes whether an expense is an allowable cost. If Company A is unwilling to set aside funds up front, an environmental indemnity agreement can serve a similar function. The parties will need to agree upon what types of claims will trigger the indemnity, how long the indemnity agreement will remain in place, and the process for raising a claim. The parties should also determine whether the environmental indemnity should be assignable to subsequent purchasers. Environmental insurance can be another mechanism for addressing Company B's concerns about known or suspected contamination on a site. A Pollution Legal Liability policy will generally protect Company B (and potentially Company A as well) against claims relating to "unknown" environmental conditions on the site, regulatory re-openers, and legal defense costs. Another type of insurance is the "Cost Cap" insurance policy, which will protect the party conducting a cleanup from cost overruns. This type of insurance is typically available only for "significant" cleanups costing $2 million or more, and will require significant underwriting by the insurance carrier. Another option to address known contamination on a site is to have the party who will be responsible for the cleanup enter into a Guaranteed Fixed Price Remediation (GFPR) or Performance Based Contract with an experienced environmental consulting firm offering that type of service. If properly structured, the GFPR contract can offer many of the same types of benefits as a Cost Cap insurance policy. Nevertheless, the proposed GFPR contract must be reviewed carefully to ensure that it does not contain significant gaps in the proposed coverage. Finally, it is important for the parties to decide who should be responsible for conducting any necessary cleanup on a site and whether this cleanup should occur pre- or post-closing. If Company B is planning significant redevelopment on the site, there are advantages in Company B having control over the timing and scope of the remediation process. Company A, however, may want greater control over the scope (and therefore cost) of any planned cleanup. It will, however, be more difficult for purchasers to recoup "voluntary" cleanup costs from other Responsible Parties in the wake of US Supreme Court's decision in *Cooper v. Aviall*, 543 U.S. 157 (2004).

Litigation weighing you down?

It's no surprise you feel the world is on your shoulders. When you're facing significant litigation, the stakes are high—and the case load heavy. We can help. Our Fraud Investigation & Dispute Services professionals work with the world's largest law firms to help them better manage and resolve high-risk litigation. With more than 1,000 highly trained personnel throughout the world, we investigate fraud, research and quantify economic damages, value intellectual property, help prepare complex insurance claims, and organize electronic evidence. Look us up. We'll lighten your load. ey.com/us/disputes

For more information, contact:

Steven Kuzma
Americas Managing Partner
(404) 817-4280
steven.kuzma@ey.com

Steve Schell
Americas Growth Leader
(312) 879-6968
steve.schell@ey.com

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Once the **environmental** due diligence process begins, Company A needs to recognize that Company B's **findings may trigger** environmental release reporting or other types of environmental **disclosure obligations.**

Expanded SEC Requirements for Environmental Disclosures

Mergers and acquisitions and other types of corporate and real estate transactions are subject to Sarbanes-Oxley requirements. Environmental issues are already a target of the SEC disclosure rules.

In particular, corporations are already subject to the requirement to provide a description of their environmental obligations in their annual reports; to disclose any material legal proceedings; and to disclose environmental issues in their management discussion and analysis (SK 103).

Staff Accounting Bulleting (SAB) No. 92 requires that a corporation disclose estimates for accrual and disclosure of environmental liabilities in its reserves. This disclosure obligation was enhanced further by the release of FAS 143, which revises the accounting treatment of Asset Retirement Obligations (ARO). FIN 47 was issued to clarify that *any* current legal obligation to take action upon retirement of an asset must be booked as an ARO.

Many companies are also voluntarily reporting on global warming issues. The federal government has not yet enacted a federal requirement to report greenhouse gas emissions (GHG), but many states have. Even if there is no federal or state requirement, many companies are voluntarily reporting these emissions because of public interest pressure to do so.

Finally, while there has not been a lot of enforcement by the SEC in this area, there is more interest than there was in the past. The SEC took a major enforcement action against a company in the chemical industry this past year because of its alleged underreporting of its cleanup reserves. This was the first such action in more than ten years.

Due Diligence and Contamination: AAI, Landowner Liability Protections, ASTM E 1527-05 and *Aviall*

Environmental due diligence is also being impacted by Congressional changes made to the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA or "Superfund") in 2002. The 2002 Amendments provided two new potential defenses to CERCLA liability, and clarified an older defense (collectively, these three defenses are referred to as the "Landowner Liability Protections," or LLPs). The LLPs include:

- *Bona fide* prospective purchaser defense (BFPP) (a prospective purchaser may acquire property *with prior knowledge* that the property is contaminated and still qualify for this defense);
- Contiguous property owner defense (CPO) (this defense is available to a property owner who acquired the property without knowledge of any contamination being present, and subsequently learned that the property had been adversely impacted by releases from other properties); and
- "Innocent" landowner defense (the property owner had no knowledge of, or reason to know of a release, and conducted appropriate due diligence).

In order to qualify for the any of these liability defenses, Company B must do a number of things, including:

- Conduct "All Appropriate Inquiries" in accordance with EPA's final rule or ASTM E 1527-05 (AAI);
- Provide full cooperation to environmental agencies and comply with any information requests;
- Comply with land use restrictions and institutional controls;
- Not be affiliated with the prior owner or any Potentially Responsible Party; and
- Take "reasonable steps" and exercise "appropriate care" regarding releases or threatened releases, preserve institutional and engineering controls, and comply with release reporting obligations.

The requirement to conduct "all appropriate inquiries" (AAI) is a threshold requirement under each of these potential defenses. AAI can be satisfied by following EPA's Final AAI Rule (69 *Fed. Reg.* 66, 070) or the updated ASTM Standard Practice on Phase I ESAs (ASTM E 1527-05).

Environmental due diligence may be impacted further by the U.S. Supreme Court's decision in *Cooper Industries, Inc. v. Aviall Services, Inc.,* 543 U.S. 157 (2004). This decision held that a purchaser may not bring a CERCLA §113 contribution action against other Responsible Parties unless it has been sued or entered into a judicial settlement. As a result, a purchaser now has a stronger motivation to qualify for one of the LLPs so that it may bring a CERCLA §107 cost recovery action. In our case, if through its environmental due diligence, Company B learns that Company A had "voluntarily" remediated a number of contaminated sites but had not yet secured contribution from the other PRPs, then in the post-*Cooper v. Aviall* world, the moneys Company A

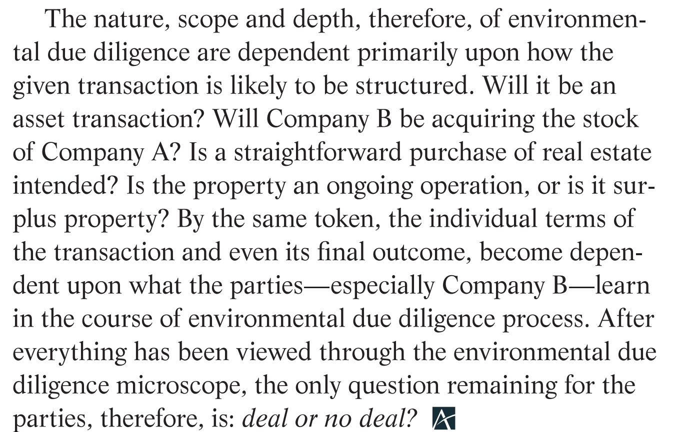
spent on these sites are no longer recoverable, thereby making Company A "less v aluable" in Company B's eyes.

Please note, the US Supreme Court has agreed to review whether Section 107 of CERCLA includes an implied right of contribution among PRPs that do not qualify for one of the LLPs. Some Circuit Courts have found such a Section 107 contribution right to exist. Without such a right, a PRP who conducts a "voluntary" cleanup has no CERCLA cause of action. The Supreme Court's holding on this matter will have to be taken into account when negotiating a deal.

Transaction Structure Key to Environmental Due Diligence

Once the environmental due diligence process begins, Company A needs to recognize that Company B's findings may trigger environmental release reporting or other types of environmental disclosure obligations. These findings may affect the type of representations and warranties that Company B expects Company A to provide.

The environmental due diligence process will be used by Company B to identify environmental conditions, risks and constraints (and may be used to seek a price reduction or other concessions in the deal).



From Company A's perspective, it is important to limit open-ended risks that may be created by the environmental due diligence process and to identify an individual within the company who will continue to monitor and manage the environmental issues post-closing.

Finally, it is important to understand how any environmental indemnities that have been agreed to as part of the deal can be triggered, and to establish a process for doing so.

The nature, scope and depth, therefore, of environmental due diligence are dependent primarily upon how the given transaction is likely to be structured. Will it be an asset transaction? Will Company B be acquiring the stock of Company A? Is a straightforward purchase of real estate intended? Is the property an ongoing operation, or is it surplus property? By the same token, the individual terms of the transaction and even its final outcome, become dependent upon what the parties—especially Company B—learn in the course of environmental due diligence process. After everything has been viewed through the environmental due diligence microscope, the only question remaining for the parties, therefore, is: *deal or no deal?*

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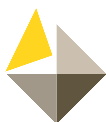

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