

Update: Top Ten Environmental Due Diligence Considerations for Acquiring Companies and Assets in the U.S. Energy Sector

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Client Advisory

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With a variety of new federal and state environmental and “climate change” regulations, it is time to re-visit the essentials of environmental “due diligence”^[1] for the U.S. energy sector.

Due diligence is a broad term that refers to the investigations that corporations typically carry out prior to acquiring other corporations, assets or real estate. In complex mergers and acquisitions, corporations are wise to assemble a due diligence team that includes in-house staff, outside counsel, financial experts and environmental consultants. The wide array of federal and state laws that have comprehensively regulated air, water and land pollution since the 1970s make environmental due diligence essential.

For the energy sector, the required due diligence might be beyond the norm because of unique developments in the United States that specifically target the energy sector. For instance, under the Clean Air Act, the U.S. government construes certain upgrades to energy facilities as “major modifications,” which triggers the need to install expensive pollution control equipment. Many owners of power plants view changes within a facility as “routine maintenance,” which would not require installation of pollution control equipment. The U.S. government has sued some companies over these disagreements and settlements are sometimes valued at hundreds of millions of dollars, with some settlements over a billion dollars. Thus, for the energy sector, a routine review of requisite permits and compliance reports might not be adequate.

Additionally, federal and state governments continue to target the energy sector when developing new regulations. New rules include proposed new source performance standards to limit carbon dioxide emissions from power plants as well as cap and trade programs that reduce impacts from power plant emissions on neighboring states. It is important for a buyer of an energy facility to understand these types of issues in order to best estimate the acquisition’s true costs.

What follows are ten basic considerations for carrying out due diligence for the energy sector.

1. Conduct phase 1 environmental site assessments in compliance with ASTM standards.

The first step in most due diligence projects should be the preparing of a basic environmental assessment to assess conditions at the plant, facility, storage units or other assets to be acquired. Under the primary federal law governing liability for hazardous substances, as well as many of its state counterparts, financial responsibility for hazardous conditions may trail companies for many years—even after they’ve sold contaminated property. Additionally, the current owner of contaminated property is liable for hazardous conditions even if it did not cause or contribute to those conditions.^[2]

The American Society for Testing and Materials, commonly referred to as ASTM, has established widely accepted protocols for carrying out environmental due diligence. For example, an initial “Phase I” inquiry into the use and history of a site should conform to ASTM Standard E1527-05. If the Phase I inquiry turns up serious concerns, a Phase II environmental site assessment (which typically involves sampling and testing) may be necessary. These preliminary inquiries can help buyers establish liability defenses under federal law, even if they uncover certain contamination in the process. They are also a necessary first step in acquiring environmental insurance, which is often available to cover unknown liabilities.

2. Identify the environmental compliance officer at each facility.

As part of due diligence, it makes sense to request permission to speak with the environmental compliance officer of each facility. In fact, ASTM Standard E1527-05 recommends that approach. If no one can tell you what environmental permits are in place, where spill reports are kept and whether any authorizations are about to expire, consider that a warning sign about how the facility, building or asset has been operated in the past.

3. Identify applicable environmental permits and transfer requirements.

Most energy facilities have a host of environmental permits that will need to be transferred should the acquisition go forward. Look in particular for expiration dates and transfer requirements for each permit; in some cases, transfer requirements are described in state administrative procedures. This is a critical pre-acquisition task because some state regulators require prior notice to transfer air, water and waste permits. Others provide generous grace periods in which to transfer permits to new owners.

Contracts for electricity or fuel might require either pre- or post-closing notices to the buyer or seller of the electricity or fuel, as well as the state’s public utility commission. Thus, part of the due diligence review involves review of contracts, service agreements and public utility regulations in order to understand all transfer requirements.

A company might have been the subject of an environmental enforcement action that resulted in a consent decree or order. Often, the provisions include very specific procedures and conditions for the transfer of an asset. Thus, in dealing with a federal consent order, it is very important to understand when and if to inform the U.S. Department of Justice or other federal agency. For expired or missing permits, a sale may be a good time to come clean with regulators.

4. Look at Local Zoning.

A buyer should also understand the local zoning for all assets to be purchased. Traditional zoning in the United States is premised on the strict separation of uses (industrial, commercial and residential). The good news is that even if the local zoning prohibits the kinds of uses that are ongoing, they may be “grandfathered” because they pre-date the imposition of zoning controls. The bad news is that most municipalities, while allowing grandfathered uses to persist, prohibit any expansion or alteration of the grandfathered use.

5. Work with a law firm that has access to local counsel or local environmental consultants who are best-situated to know about quirky local permitting requirements. Land-use and environmental permitting requirements vary widely from state to state and city to city. Some states, like New Jersey, require state approval before the sale of any industrial facility; most states do not. Some counties require companies to obtain permits to store hazardous substances onsite; many others have no such requirement.

For complicated sites or acquisitions involving multiple locations, seek out consultants who have the ability to seek advice from local professionals. For example, Carter Ledyard & Milburn LLP is a member of the legal consortium Meritas, a network of unaffiliated law firms that assist each other on deals involving multiple jurisdictions.^[3]

6. Identify sale agreements and other contracts that might include indemnities that benefit past or future owners. If acquiring a corporate entity, it is important to review the indemnification provisions of past contracts, which often have expiration dates. Also, keep in mind that some states require environmental indemnities to specifically mention environmental concerns or hazardous substances in order to successfully allocate liability; in other words—a generic indemnity from a seller to buyer (or lessor to lessee) may not transfer environmental liability.

If a seller holds a valid indemnity from a prior owner, this may be one of the best reasons to acquire the seller's corporate entity rather than just its assets. By acquiring the seller's corporate entity, the buyer may obtain the benefit of the indemnity, which the seller likely could not assign to the buyer in an asset sale.

7. Identify forthcoming regulations.

The U.S. Environmental Protection Agency ("EPA") and states are developing numerous initiatives to address climate change. Although the United States has not adopted climate change legislation or joined the international climate change treaty, the Kyoto Protocol, the EPA is developing regulations for greenhouse gas emissions under the Clean Air Act. For example, the EPA proposed New Source Performance Standards for power plants — the first stationary sources to be regulated for carbon emissions. The Cross-State Air Pollution Rule, if upheld by the federal courts, establishes sulfur dioxide and nitrogen oxide caps on power plants that are intended to ensure upwind states do not significantly contribute to downwind state nonattainment of ozone and fine particulate matter. New EPA standards also regulate mercury and air toxic emissions from coal and oil-fired power plants. Moreover, many states are adopting new regulations regarding fuel oil specifications, including requiring sources to operate on lower sulfur fuel oil.

At the state level, the most notable legislative initiatives are cap-and-trade programs. In most northeastern states, the Regional Greenhouse Gas Initiative ("RGGI") already requires power plants to acquire carbon credits that are sold at quarterly auctions. California expects to implement its own cap-and-trade program in late 2012. Other states have considered cap-and-trade programs through the Western Climate Initiative and Midwest Greenhouse Gas Reduction Accord, but these efforts are far from implementation.

Where there is a proposed regulation available for public comment, EPA and other federal agencies often prepare a Regulatory Flexibility Analysis or Regulatory Impact Statement that identifies the expected costs of the program. Thus, a refinery that is likely to be subject to a new EPA air toxic regulation will usually review the Regulatory Impact Statement to identify add-on controls and their costs.

One can also review trends on the U.S. Energy Information Administration website at www.eia.gov, which provides information on expected costs for the energy sector to comply with future regulations. Participating in industry trade associations or air and waste management associations is another way to keep abreast of new environmental rules.

8. Look at leases.

Leases routinely include broad and sometimes illogical prohibitions, such as on "storage of hazardous materials" at an industrial site. Identify such prohibitions before acquisition and, if problematic, ask the seller to obtain assurances from the owner that the lease terms do not prohibit the kinds of operations that are planned.

9. Review Federal and State Enforcement Initiatives

In addition to understanding forthcoming regulations, a buyer can also review federal and state enforcement initiatives to gain a better understanding of enforcement priorities and future risks.

Recent federal settlements for alleged violations of Clean Air Act permits, including Prevention of Significant Deterioration ("PSD") and New Source Review ("NSR"), have been very high. One of the largest involved American Electric Power, whose \$1.4 billion settlement included a \$15

million civil penalty and \$60 million for environmental mitigation. Other examples include the following: (a) under a 2002 settlement, Public Service Enterprise Group of New Jersey had to install pollution control devices at two of its coal-fired power plants, pay a \$6 million penalty and undertake \$3.25 million in environmental mitigation projects; (b) under a 2003 settlement, the Wisconsin Electric Power Company agreed to spend \$600 million to install pollution control equipment; (c) under a 2006 settlement, the Southern Indiana Gas and Electric facility agreed to spend \$30 million on pollution control equipment and pay a \$600,000 civil penalty; (d) under a 2007 settlement, the East Kentucky Power Cooperative agreed to spend \$650 million in pollution control upgrades and pay another \$750,000 in civil penalties; and (e) under a 2009 settlement, the Kentucky Utility Company agreed to spend \$135 million on pollution controls and pay a \$1.4 million civil penalty.^[4] A review of EPA's enforcement initiatives, including reviewing cases before the EPA Environmental Appeals Board, might help a buyer gauge potential risks from the purchase of a new energy facility.

Buyers can conduct similar reviews for Clean Water Act issues, such as monitoring states' issuance of "Section 401" water quality certificates, which might include new standards for cooling water intake structures.

10. Consider incentives.

Review www.dsireusa.org, a project funded by the U.S. Department of Energy, for various tax credits, grants and other benefits that states and cities are offering to clean-energy companies. Other incentives may be available as well. For example, many states offer financial incentives for the use or redevelopment of brownfields, which is land whose use or development is complicated by the presence of hazardous substances—often an ideal location for a new power plant, manufacturing facility or solar panel array. Others states and cities offer financial incentives for environmentally sustainable buildings, solar panels, green roofs, and other desirable building characteristics. Many municipalities provide tax breaks for facilities siting or expanding into economic development zones.

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[1] Adam Aston, "Utilities Turn to Mergers as Demand for Power Slows," N.Y. Times, June 16, 2011. [2] The primary reason is the 1979 Comprehensive Environmental Response Compensation and Liability Act (aka "CERCLA"), which states that any current owner or operator, any owner or operator at the time of disposal and any person that arranged for disposal, among others, shall be responsible for all costs of removal and remediation of hazardous substances. There are defenses to this liability, but the burden of proof will fall on the person asserting those defenses. For example, under CERCLA, a bona fide prospective purchaser is a buyer that conducts all appropriate inquiries prior to acquisition and complies with certain federal laws regarding any contamination that is uncovered (e.g., avoids exacerbating the conditions). 42 U.S.C. § 9601(40) [iii] www.meritas.org; Carter Ledyard & Milburn LLP is a member of Meritas. [iv] EPA Coal Plant Settlements, from Source Watch, available at www.sourcewatch.org.

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