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Update: Top Ten Environmental Due Diligence Considerations for Acquiring Companies, Assets, and Real Property Interests

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Client Advisory

October 9, 2017 by Christine A. Fazio, Christopher Rizzo and Julie A. Weisman

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.

Environmental due diligence is not just limited to corporate acquisitions. Often, developers will need an array of environmental and land use permits that will require considerable environmental due diligence, including on land that is leased or for easements associated with the development.

What follows are ten basic considerations for carrying out environmental due diligence.

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, other assets, and the land. 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 and property owners for many years—even after they've sold contaminated property. Additionally, the current owner of contaminated property may end up liable for hazardous conditions even if it did not cause or contribute to those conditions (or certainly may need to spend considerable legal fees to prove the landowner did not cause or contribute to the condition).

The American Society for Testing and Materials, commonly referred to as ASTM, has established widely accepted protocols for carrying out environmental due diligence. If the Phase I inquiry turns up serious concerns, a Phase II environmental site assessment (which typically involves sampling and testing) may be necessary. Ask that the assessment also include some extras such as an examination for asbestos or lead in older buildings. 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. 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.

Many 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 possibly 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. It is also important to review news articles for the area to determine if there are any pending community issues. For instance, a developer would not want to buy a lot with the intent to construct a 15-story building if there is a community movement to down-zone the area to allow only 6-story buildings.

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.

6. Identify sale agreements and other contracts that might include indemnities that benefit past or future owners.

If acquiring a corporate entity or real property, 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.

Understanding possible new regulations that may be adopted by the U.S. Environmental Protection Agency ("EPA") and states is essential to understand the risks of purchasing a new facility. For example, understanding pending regulations or policy initiatives of federal, state and local governments is important to appreciate possible future costs to comply with new regulations.

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 existing leases and easements.

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. A property might also contain an exclusive easement, such as for a utility line or future roadway, that could limit development on a portion of a property or may sever the property is such manner that it impacts the value of the land or ability for future development.

9. Be Careful of Commitments Made in Access Agreements.

Often developers in locating possible sites for a development project will want permission from the landowner to conduct environmental and cultural resource studies (particularly if federal or state permits or other approvals will be required). In order to conduct such on-site due diligence, a developer normally needs to enter into an access agreement with the landowner. Many landowners are concerned that if the developer starts digging holes on the property, petroleum product or other hazardous material may be discovered that would trigger the landowner to possibly have to undertake costly remediation. Thus some landowners will include a section on hazardous materials that state that if the developer discovers hazardous materials on the premises, the developer must remediate the entire parcel and adjacent parcels. Signing such an agreement puts a developer at risk to having to spend considerable funds on remediating a pre-existing condition that it did not cause. Accordingly, review access agreements carefully before signing, including making sure there is no obligation to remediate if contamination is "discovered".

10. Consider incentives.

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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Endnotes

[1] 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 CERLCA, 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)

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