Striking a Balance in Environmental Due Diligence

By Dennis Papa

Congratulations—your M&A transaction went off without a hitch, and you're now the proud owner of a specialty chemicals manufacturer. Included with your purchase are any inherited environmental liabilities of your new portfolio company—contaminated soil or groundwater on the property, underground storage tanks, or chemical releases, for example.

To protect yourself as a buyer, a thorough investigation before the sale is essential. The Phase I environmental site assessment has become a useful due diligence tool to consider potential environmental liability during the M&A process. A key factor when conducting this assessment for acquisitions of complex properties, such as chemical plants and other heavy industry assets, is to be sure that the Phase I does what you need it to do.

Performed by a certified environmental professional, a proper Phase I should help the buyer avoid liability for identified recognized environmental conditions and to qualify for the so-called "innocent landowner" defense provisions under the federal Superfund law—formally named the Comprehensive Environmental Response, Compensation, and Liability Act, or CERCLA.

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To provide a common standard for a proper Phase I, the U.S. Environmental Protection Agency issued the All Appropriate Inquiries Rule, which details a process for evaluating a property's environmental conditions and the prospect of contamination. The EPA has also endorsed the assessment guidance developed by the American Society for Testing and Materials. The current ASTM Phase I standard, E1527-13, has largely become the benchmark for environmental due diligence.

One of the complicating factors when assessing active industrial sites is that other laws apply in addition to CERCLA, including the Resource Conservation and Recovery Act, Clean Air Act, Occupational Safety and Health Act, and a host of others whose provisions are not necessarily considered in the All Appropriate Inquiries Rule.

One option for a thorough assessment is more investigation, usually in the form of a Phase II ESA, but this can add time for sampling and analysis to the due diligence period. It may be overly intrusive or duplicative for the purposes of transactional due diligence at industrial plants that have already had investigations and regulatory compliance activity. Given these factors, how can environmental investigation be balanced to evaluate environmental risk and also determine whether to investigate further, negotiate a more favorable transaction or walk away?

Is There a Phase One and a Half?

There are some methods whereby a prospective purchaser can use available resources to advance beyond what is required in a Phase I assessment and obtain the necessary information.

- **Beyond the data room.** The environmental professional you engage to perform a Phase I assessment should not be limited to reviewing only existing reports provided by the facility or available in the data room. Researching information from state regulatory files, such as previous ESAs, permits and correspondence will shed light on environmental conditions. In fact, ASTM E1527-13 includes specific language addressing review of regulatory records. If the target property or adjoining property is identified in a government records search, then pertinent regulatory files associated with the listing should be reviewed, or the environmental professional must provide a justification as to why a review is not needed.
- **Due care requirements and transfer rules.** Some states regulate how certain properties with hazardous materials or releases are handled after transfer. For example, Michigan due care laws regulate access and response activities related to contaminated sites. Other states, such as New Jersey and Indiana, have industrial property transfer laws with penalties for noncompliance. Due care obligations are not necessarily related to an owner or operator's liability and can apply to nonliable parties. Be sure your environmental professional examines these requirements.

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- **Compliance audits and permits.** Complex operating facilities may still need more in-depth investigation, such as environmental health and safety audits or review of existing audits. This will ensure that proper permits are in place and the facility is in compliance with all applicable environmental laws. Another important transfer consideration for active permits is to determine if and when environmental permits can be transferred to the new owner or if they must be reissued.
- **Consider business environmental risk.** This is defined by ASTM E1527 as "a risk which can have a material environmental or environmentally driven impact on the business associated with the current or planned use." Items like asbestos, lead-based paint, radon, mold, historic resources, flood plains, and ecological resources such as wetlands and endangered species are specifically excluded from the standard Phase I scope, but they can still have a material effect on the asset and future operations.
- **Lender reliance letters.** When financing is involved, lenders will undoubtedly ask to rely on the findings of your environmental consultant's reports. The consultant should be made aware of this requirement early in the process so an agreement can be reached on language and limitations in the reliance letter, which assesses the conditions of a potential contamination site. This can become a contentious issue if third-party lenders insist on exact language and liability insurance limits in the reliance letter but consultants challenge such requirements. Avoid standoffs in the heat of closing and address reliance early in the process.
- **If contamination exists …** Where past regulatory responses or cleanup actions were performed, the seller may have obtained formal regulatory approval, often termed a certificate of satisfactory completion or closure letter. Carefully review the closure language, as it may provide descriptions on limiting future liability, including reciprocal protection from federal regulators and deed restrictions on use.

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After the Phase I, it may still be necessary to perform a Phase II ESA, perhaps to provide a baseline condition before sale or as required by insurance underwriting. However, a few small steps beyond the typical Phase I will reduce the need for intrusive investigations and limit the new owner's liability. //

—**Dennis Papa**, PE, BCEE, is the founder and principal engineer of dpSTUDIO Environmental Consulting & Design LLC. Contact him at dp@dpstudioenvironmental.com.

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