Cost-Effective Environmental Due Diligence in Corporate Mergers and Acquisitions

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Environmental due diligence is playing an increasingly important role in corporate and real estate transactions. Unfortunately, parties often fail to perform sufficient environmental due diligence or do not complete it early enough to be able to use the information effectively in the transaction. As a result, parties to a transaction may find themselves saddled with unexpected liabilities. This article discusses how to tailor a due diligence program to the particular needs of a transaction and how to use the information developed during environmental due diligence in a manner that will bring maximum value to the transaction.

Why Is Environmental Due Diligence Necessary?

Federal and state environmental laws enacted during the past two decades impose substantial liabilities on a wide range of entities. For example, under the federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA or Superfund), 42. U.S.C. §§ 9601 *et seq.*, current and former owners or operators of facilities (owners or operators) can be held liable for the cleanup of hazardous substances. Cleanup liability can be imposed on owners or operators even if they were not responsible for the contamination. Companies that arranged for the disposal of hazardous substances (generators), as well as those entities that transported the wastes and selected the disposal site (transporters) may also be liable for the cleanup. 42 U.S.C. § 9607(a)(1)-(4). These four types of liable parties are usually referred to as potentially responsible parties (PRPs).

CERCLA provides for retroactive and strict liability. This means a person may be found legally and financially responsible for the cleanup of the contamination even if its actions were lawful at the time and in no way negligent. Federal court decisions interpreting CERCLA § 107(a) have also found that the liability is joint and several. This means that a PRP may be held responsible for the entire cost of the cleanup, even though there may be other PRPs for a site. *See, e.g., Bedford Affiliates v. Sill*, 156 F.3d 416 (2d Cir. 1998); *United States v. Alcan Aluminum Corp.*, 964 F.3d 252 (3d Cir. 1992); *O'Neil v. Picillo*, 883 F.2d 176 (1st Cir. 1989).

Federal courts have broadly construed CERCLA and have expanded the liability of parent corporations and purchasers of corporate assets. Traditionally, state law has governed liability of corporations. A basic tenet of corporate law has been that a corporation is a separate entity from its shareholders, who are protected from the liabilities of the corporation by a corporate veil. In order to hold a shareholder liable, plaintiffs have to pierce this corporate veil. To hold a parent responsible for the liabilities of its subsidiary, a plaintiff usually had to show that the parent dominated the subsidiary to the point that it had no separate identity and that honoring the corporate form would result in injustice. To ensure uniform enforcement of CERCLA, however, courts adopted a more liberal federal common law test. In *United States v. Bestfoods*, 118 S. Ct. 1876 (1998), the United States Supreme Court ruled that a parent corporation can be considered a CERCLA "operator" of a subsidiary's facility only if the parent exercises actual control over that facility. The focus for "operator" liability is not the relationship of the parent to the subsidiary but the relationship between the parent corporation and the individual facility. A parent may also be held liable as an "owner" of the facility under a "piercing the corporate veil" analysis.

Likewise, the liability for purchasers of corporate assets has been expanded. The traditional rule has been that a purchaser of stock assumes all of the liabilities associated with a corporation but that an asset purchaser does not incur liability unless the purchaser assumed those liabilities, the transaction constitutes a de facto merger, the new corporation is a continuation of the old corporation, or there is fraud. Because plaintiffs (notably the United States) had problems imposing liability on successor corporations under these four exceptions, federal courts established a new test for imposing liability under CERCLA. Under the doctrine known as the Continuity of Enterprise, an asset purchaser may be responsible for the liabilities of its predecessor if the purchaser simply continues the same business operations. Among the factors courts examine to determine whether an asset purchaser is a successor corporation are whether the new business retains the same officers, uses the

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same facilities, makes the same products, and retains most of the seller's workforce. *United States v. Mexico Feed and Seed Co., Inc.*, 980 F.2d 478 (8th Cir. 1992).

There are only three statutory defenses to CERCLA liability: act of war; act of God; and, the third-party defense. CERCLA § 107(b), 42 U.S.C. § 9607(b). The most commonly asserted defense is the third-party defense, under which a defendant must show that the release of hazardous substances was caused *solely* by a third party who was not in a contractual relationship with the defendant. CERCLA § 107(b)(3), 42 U.S.C. § 9607(b)(3). This defense is generally unavailable to purchasers when the seller caused the contamination because the sales agreement would qualify as a contractual relationship. Likewise, landlords have been unable to assert the defense when a tenant caused the contamination because a lease constitutes a "contractual relationship." Even if a defendant can get past the contractual relationship barrier, there are two additional hurdles it must satisfy before it can assert a third-party defense—that the owner took reasonable precautions against the acts or omissions of third parties and that it exercised due care regarding the hazardous substances at the property. For example, the purchaser cannot allow previously deposited drums to deteriorate or allow groundwater contamination to continue to migrate if it wants to be able to assert this defense.

Because the third-party defense was unavailable to new landowners who did not cause the contamination at a site, Congress enacted the innocent landowner's defense in 1986. This defense provides that a purchaser is not considered to be in a contractual relationship and thus is able to assert the defense if the purchaser can establish that it did not know nor had no reason to know about the contamination. CERCLA § 101(35)(A), 42 U.S.C. § 9601(35)(A). To establish that it had no reason to know, the purchaser must show that it undertook a reasonably appropriate inquiry into the past uses and practices of the property that was consistent with good commercial and customary practices. In reality, this defense has been largely unavailable because most courts have ruled that if the purchaser did not discover the contamination prior to the transaction, it probably did not conduct a sufficient inquiry.

There are no uniform federal due diligence standards despite their importance. CERCLA provides only that purchasers use "appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice." In determining whether "all appropriate inquiry" was made, a court is required to examine "any specialized knowledge or experience on the part of the defendant, the relationship of the purchase price to the value of the property in an uncontaminated state, commonly known or reasonably ascertainable information about the property, the obviousness of the presence or likely presence of contamination at the property, and the ability to detect such contamination by appropriate inspection." CERCLA § 101(35)(B), 42 U.S.C. § 9601(35)(B).

Although buyers usually perform environmental due diligence to preserve the innocent purchaser defense, there are other reasons why companies should perform it. If done properly and early enough in a transaction, environmental due diligence can be used to achieve a wide range of business objectives and bring value to the process. Properly designed and implemented due diligence can more than pay for itself in terms of liabilities avoided and costs saved. Some of the reasons for performing environmental due diligence include:

- A purchaser who wants to assert the third-party defense must show it exercised due care regarding hazardous substances at a facility. Unless a purchaser thoroughly examines a site, it may not become aware of contamination and thus may not take the steps necessary to document and assert the defense successfully.
- A purchaser can use the information to establish an environmental baseline for the facility to show what conditions existed prior to the closing. In this way, the purchaser can demonstrate in any future litigation both the contamination it knew about and also that the contamination was not attributable to its operations.
- If environmental due diligence is performed early enough in a transaction, the parties can use information to allocate liabilities identified during the investigation, to draft indemnities, or perhaps to re-price the deal. The information can also be used to obtain environmental insurance that might help allocate environmental liability.
- Some states have financial assistance programs that can help pay for contamination associated with underground storage tanks (USTs) or dry cleaners. Parties that are aware of such contamination sources can determine the availability of funding sources and use this information in contractual allocations of these liabilities.
- Nearly 70 percent of corporate acquisitions fail to achieve the business objectives that were anticipated when the purchaser agreed to the transaction. One of the principal reasons for poor performance is difficulty in post-acquisition integration. The environmental practices of a seller often differ from those of the purchaser; preacquisition due diligence can help the purchaser project the environmental costs of these changes and plan operational and cultural changes that may be necessary.
- A purchaser must evaluate the various facilities to be acquired in an effort to understand how the new business will fit into its current structure. The purchaser that finds itself with excess production capacity and obsolete plants will need a plan for streamlining or restructuring operations and closing obsolete plants. Comprehensive pre-acquisition environmental due diligence helps the purchaser understand the environmental implications of these choices and avoid or minimize unnecessary environmental costs (e.g., when inactivated plants are sold).

- EPA and nearly two dozen states have implemented self-reporting auditing policies, under which companies that voluntarily disclose violations discovered during due diligence or an environmental audit can obtain significant reductions in penalties. *See Incentives for Self-Policing; Discovery, Disclosure, Correction and Prevention of Violations*, 65 Fed. Reg. 19,618 (Apr. 11, 2000). If a purchaser uncovers violations during its due diligence, it may be able to take advantage of these policies. If, however, EPA or state agencies perform the site inspection after the purchaser takes control of the business, and discover violations, the purchaser will no longer be able to take advantage of the penalty eduction policies. One note of caution: if environmental site assessments do identify violations and the purchaser does nothing about them, their inclusion in the reports can later be used by government regulators to allege that the purchaser knowingly violated the law and is therefore criminally liable.
- The federal Securities and Exchange Commission (SEC) has begun to insist on more comprehensive disclosures of environmental liabilities in the disclosure statements that publicly traded companies are periodically required to file. A purchaser who conducts comprehensive environmental due diligence can use this information also to assess its SEC disclosure obligations without having to conduct another expensive environmental compliance audit after the acquisition.
- Partly because SEC rules may require sellers to reflect indemnities on their balance sheets, sellers are increasingly reluctant to provide purchasers with environmental indemnities. Accordingly, it is important that the purchaser understand the environmental liabilities associated with the business, so that those risks are adequately reflected in the purchase price or other consideration is given in the transaction.
- There has been an increase in bodily injury and property damage claims for persons and property exposed to hazardous substances. Parties to a transaction should be aware of hazardous substances that migrate off site or air emissions that could lead to such liability.
- Environmental audits can be used by lenders to evaluate the likelihood that a heavily leveraged borrower might be required to fund a cleanup that could render it insolvent. Lenders or purchasers can use environmental audits to screen or exclude properties from the transaction or to identify properties that can be foreclosed.

Mechanics of Performing Environmental Due Diligence

Neither CERCLA nor EPA guidance documents interpreting the scope of the innocent purchaser's defense precisely describe what constitutes an "appropriate" inquiry. *See* Announcement and Publication of Final Policy Toward Owners of Property Containing Contaminated Aquifers, 60 Fed. Reg. 34,790 (July 3, 1995); Announcement and Publication of Guidance on Agreements with Prospective Purchasers of Contaminated Property and Model Prospective Purchaser Agreement, 60 Fed. Reg. 34,792 (July 3, 1995); Guidance on Landowner Liability Under Section 107(a)(1) of CERCLA, De Minimis Settlements under Section 122(g)(1)(B) of CERCLA, and Settlements with Prospective Purchasers of Contaminated Property, 54 Fed. Reg. 34,235 (Aug. 18, 1989). As a result, this determination is made on a case-by-case basis. The few courts that have addressed the issue have not consistently interpreted the meaning of "appropriate," and EPA has often taken the position that an audit that failed to detect contamination was not an appropriate inquiry. Some of the forty states that have enacted their own versions of CERCLA have established criteria that must be followed for environmental due diligence, but, for the most part, parties must develop a program that is tailored to the particular circumstances of the transaction.

The American Society for Testing and Materials (ASTM) published two standards (discussed in detail below) for conducting environmental assessments on commercial real estate that are intended to establish what constitutes "good commercial and customary practice" under CERCLA. ASTM standards are designed to satisfy only the requirements of the CERCLA innocent purchaser defense, although recently adopted changes to the ASTM standards for Phase I Environmental Site Assessments expand the scope to include "business risks." The ASTM standards do not address requirements of other federal or state environmental laws. Furthermore, non-CERCLA liability issues such as asbestos-containing materials, lead-based paints, lead in drinking water supplies, or wetlands are not normally covered.

The first step after deciding to perform environmental due diligence is to assemble and review existing information on the facilities or properties involved in the transaction any existing reports evaluating environmental conditions. There are also a number of databases that may be used to determine whether any of the facilities have been subject to enforcement actions or have been placed on the list of Superfund sites, known as the National Priorities List (NPL), 40 C.F.R. pt. 300, or in the CERCLIS database. During this review, the buyer should evaluate the number and location of current and formerly owned and leased facilities and the kind of operations involved at each.

After gathering this information, a company must establish the scope of the environmental due diligence. The scope and detail of environmental due diligence will vary significantly from deal to deal because no two transactions are alike. There are a number of factors that can influence the scope of environmental due diligence, and counsel will have to identify the constraints to determine the scope of the investigation. Factors that must be considered include

- the number and type of facilities to be investigated,
- the value of the transaction,
- the time allotted for performing the investigation,
- the funds available for performing the investigation, and
- the level of risk that the parties are willing to accept in developing remediation or liability estimates.

Although it is preferable to conduct environmental due diligence on each parcel that will be part of the transaction, parties in multi-parcel transactions may choose to restrict investigations to a limited number of properties because of cost or time constraints. Sites that are selected will usually be those that are likely to have the worst and most expensive problems, that have operations within certain SIC numbers, or that represent the most valuable properties. The size of the transaction is also a key factor. Larger deals can absorb greater environmental liability. For example, a $1 million cleanup for a $50 million transaction may not be considered a material liability but a $100,000 liability might prove to be a deal-killer for a $1 million transaction. Because each site may pose unique environmental problems, depending on its site history and because environmental management practices may vary from plant to plant, extreme caution should be used during the site-screening process.

One way of screening sites in a multiparcel transaction is for the purchaser's lawyer or in-house environmental staff to prepare an environmental due diligence questionnaire to be completed by an engineer or plant manager at each facility. This document asks general questions about the environmental practices and operating conditions at each facility. The answers help to narrow the scope of work done by the environmental consultant hired to perform the environmental due diligence—and might also alleviate some of the consultant's anticipated work. Because of time constraints and disclosure issues, this approach is rarely used. The ASTM Transaction Screen (discussed below) can also be used to identify the properties that should be investigated.

Another critical aspect of due diligence examinations is gaining access to the site and obtaining information from facility personnel. Such cooperation will not be forthcoming in a "hostile" takeover. In a "friendly" takeover, the seller, target company, or borrower may be reluctant to share information that may cause a party to back out of a deal or renegotiate the price, or that may make the government aware of previously unknown operating conditions (particularly if the operator was engaged in negotiations with the government, which might use the pending transaction as leverage for additional concessions).

Another reason operators resist divulging information is that if the transaction collapses, the operator may nevertheless be required to report the presence of contamination uncovered during the due diligence investigation. This resistance to divulging information can be softened, though, if the parties enter into a confidentiality agreement outlining what information will be divulged and how it will be handled.

Retaining the Environmental Consultant. After the scope of the investigation has been determined, the purchaser must decide whether the environmental due diligence will be performed internally or by an outside environmental consultant. If the decision is to use an outside consultant, a request for proposal (RFP) is prepared and sent to a number of consulting firms, inviting them to bid on the project. If the transaction involves a limited number of facilities or the purchaser has had significant experience performing environmental due diligence, a Scope of Work (SOW) may be prepared and forwarded to the bidders in lieu of an RFP.

An RFP describes the objectives and limitations of the work to be performed and gives the deadline for bids. If there is inadequate time to solicit bids, the attorney or client can simply select consultants based on prior experience. If a national environmental consulting firm is being considered, it is important to remember that the level of competence may vary among offices and individuals within offices. Thus, if a consulting firm is retained because of previous work, it is advisable to request the same individuals who worked on the previous transaction. The client should not directly hire by the consultant; instead, the buyer's lawyer should retain the consultant so that the opinions or conclusions contained in the consultant's report might be protected from disclosure under a legal privilege.

Reviewing Environmental Consulting Agreements. Many consulting firms use standard contracts that should be carefully reviewed by counsel prior to retaining the consultant. In addition to the standard contract terms, the contract should contain a description of the work to be performed, a cost estimate for the project, and a project schedule.

One of the more important issues involves ownership of all materials generated by the consultant. The consulting agreement should provide that all materials, including drafts, drawings, photographs, and field notes, are the property of the client and that the consultant will not release to a third party any information obtained in the investigation without the express written, consent of the client. Furthermore, the consultant should also agree to destroy any draft reports and field notes at the conclusion of the project.

Consulting agreements frequently request that the client indemnify the consultant for any injuries or losses resulting from site conditions. Because the client usually is not the party in control of the site, the client should not agree to such a provision.

Clients also are often asked to be responsible for obtaining permits or for disposal of hazardous residues

(Continued on page 124)

people will have at least some basis for ascertaining the magnitude and likelihood of potential risks.

Another way to address these issues is through the use of environmental legal liability insurance. Such policies cover the risk of remediation costs and third-party claims for personal injury and property damages. These policies are heavily negotiated and may take substantial resources to obtain. Moreover, as with the insurance policies discussed previously, they are relatively untested by courts. Environmental legal liability insurance policies are a tool that may be available, but are not necessarily the first approach that the parties should adopt. For more information on the use of insurance see the article beginning on page 88; David Franchina, *Current Developments in Environmental Risk Allocation*, ABA SEC. ENVIRONMENT, ENERGY AND RESOURCES 7TH FALL MEETING 935 (1999); and, Dinah L. Szander, *How Does Environmental Insurance Add Value,* ABA SEC. ENVIRONMENT, ENERGY AND RESOURCES 7TH FALL MEETING 287 (1999).

This article provides a general overview of the approach an environmental lawyer may want to take and the issues he or she should consider in handling a transaction involving industrial property and/or a business heavily regulated in the environmental health and safety arena. Every deal has its own quirks, and the best part of environmental transactional work is the opportunity it creates for creativity and helping a client reach its business goals. Like the role of any business lawyer, the environmental lawyer's challenge in these transactions is not to eliminate all risk for the client (a lofty but usually unattainable goal), but to identify the potential risks, work with the technical advisors to scope out the magnitude and likelihood of the risks, point out the problems that may arise if issues are left to chance and ambiguous drafting, and ensure the client understands risks and alternatives so that reasonable business decisions are possible.

Due Diligence

(Continued from page 83)

generated from laboratory analysis. Instead, the consultant should be responsible for obtaining permits, complying with the conditions of such permits, and disposing of any sampling residues.

Another important issue is insurance. The consultant should be required to maintain GCL, professional liability, automobile, workers' compensation, and employer's liability insurance and to add the client as an additional insured under the GCL polity.

Many consulting agreements provide for accrual of interest after thirty days from billing. If the client is a large corporation that cannot generate payments rapidly, the client should request a longer accrual period of sixty to ninety days. The client should also seek the right to terminate the contract for any reason and have the consultant agree not to incur any further charges upon receipt of the termination notice. (Many agreements usually provide that the consultant may finish the particular phase of the work following receipt of the termination notice.)

Preparation and Review of the Scope of Work. Before commencing the project, the environmental consultant should prepare a SOW, unless the client as part of the bid package previously prepared one. This document is probably the most critical document in the due diligence process because it determines just how the investigation will be performed. The scope of work will be developed using information that is already available from the existing company or regulatory records as well as responses to the questionnaire or transaction screen.

The scope of work describes the specific tasks to be performed, the schedule for each task, and a cost estimate for the project. It should also indicate the number of facilities to be visited, the priority of the site inspections, the extent and nature of any sampling to be performed, the kinds of substances that will be analyzed, the offsite disposal practices, and the kinds of regulatory information that will be collected.

Once the scope of work is approved, the consultant will have to determine its staffing needs. Generally, each site inspection requires two person-days, with additional two person-days for collection of regulatory information. Another couple of days will be required to prepare a draft report, and oversight by management will add another person-day to the project. A site inspection will typically cost between $5,000 and $7,000 per industrial facility, without soil or groundwater sampling. If sampling is required, this could add $10,000 to $20,000 to the cost of each site, depending on the number and depth of the wells that have to be installed, the number of soil samples taken, the kinds of parameters to be analyzed, and the time allotted the laboratory to analyze the samples.

Phase I Environmental Site Assessments. Environmental due diligence is customarily performed in phases because this is the most cost-effective methodology. Under this approach, each investigative phase is based on information gathered in the preceding phase, so, it is extremely important that each phase be performed as thoroughly as possible.

The Phase I Environmental Site Assessment (ESA) is designed to identify areas of potential soil or groundwater contamination. The Phase I ESA consists of a site inspection and a review of public and private records to ascertain the present and past regulatory and opera-

tional history of the site.

The ESA should include the following:

- Title Search. Records should be reviewed to reconstruct the chain of title as far back as possible to determine whether the property was previously used for on-site generation, storage, or disposal of hazardous materials. This information can be obtained from title abstracts, tax records, subdivision maps, building or land use permits and interviews with local officials. However, if the owner was not the operator of the site, this process may not reveal prior operating history or uses of the site.
- Historical Facility Records. Manufacturing or chemical facilities that have been in existence for a long time have probably changed their environmental practices significantly. Areas of a facility that do not appear to pose any current environmental risk may in fact have been used in the past as lagoons, landfills, or disposal areas. If hazardous materials were handled or disposed of at site locations, corrective action may be required in the future. Thus, it is important for the purchaser to review site plans, plats, engineering surveys, blueprints, and aerial or historical photographs that may locate structures, underground storage tanks, PCB transformers or capacitors, floor drains, sewer lines, lagoons, settling ponds, trenches, railroad tracks, areas of hazardous waste storage, and the presence of asbestos. Former employees who may have knowledge about past practices should also be interviewed if they can be located.

The Phase I ESA is designed to identify areas of potential soil or groundwater contamination.

- Regulatory Compliance Records. Businesses subject to environmental regulation are required to maintain a variety of records on the site and to file reports with state and federal environmental agencies. The reports include environmental permits and applications; hazardous waste manifests and notifications; monitoring and discharge reports; spill reports; underground storage tanks registrations; environmental consultant reports and correspondence; notices of violations; consent decrees; financial reports indicating expenditures for pollution-control equipment or reserves for environmental liability; insurance policies; and records and procedures for compliance with right-to-know, training, and other health and safety requirements of OSHA. When reviewing permits, the examiner should confirm that the seller is the permit holder and that the permit has not expired. Contacts with regulatory agencies must be handled with extreme care to avoid triggering reporting obligations.
- Neighboring Properties. Because nearby properties can be a source of contamination and can also be affected by contamination migrating from a facility, the consultant should observe properties within a one-mile radius and review state and federal database filings within this geographic range.
- Off-site Disposal Facilities. When purchasing a business, it is important to identify the disposal facilities to which the company sends and sent its hazardous wastes to ascertain whether potential CERCLA generator liability exists.

When the Phase I report is completed, the consultant orally reviews the results of the investigation with the client and the attorney. If time is short, more frequent oral debriefings can take place at set intervals or after investigations at certain key facilities have been completed.

Following the oral report, the consultant prepares a draft report for review by the lawyer. One of the most important tasks of the lawyer is to ensure that the report is limited as much as possible to factual observations. Conclusions or opinions regarding status of regulatory compliance or speculations on the sources of potential contamination should be deleted. The reason for this is that many clients will not be prepared to address all of the noncompliance issues raised in a report, and the existence of such findings could be used by a government agency in any subsequent civil or criminal enforcement action as evidence of willful or deliberate noncompliance with environmental laws. If the lawyer makes substantive changes to the draft Phase I report, a revised draft should be forwarded to the lawyer and a final Phase I report should not be issued until the lawyer approves the revised draft. The final Phase I report should be issued to the lawyer.

Phase II Investigation. If the Phase I ESA reveals areas of environmental concern, it is then customary to perform a Phase II ESA, which is a more extensive investigation involving soil sampling, groundwater and surface water monitoring, and stack emission sampling. The purpose of the Phase II site investigation is to investigate further the areas of potential environmental concern identified in the Phase I ESA. Many times when heavy industrial properties are involved, parties to a transaction automatically perform a Phase II site investigation.

A second scope of work must be prepared that will provide for preliminary subsurface investigation that may include soil or groundwater sampling in areas of suspected contamination. Because many sources of contamination cannot be visually observed, the Phase II subsurface investigation can use noninvasive screening methods such as metal detectors to identify buried metal structures like storage tanks, as well as a volatile organic analyzer that can "sniff" gases evaporating

through the soil from buried storage facilities or plumes of contamination.

If groundwater contamination is suspected, one or more groundwater monitoring wells may be installed. The construction of the wells will depend on the type of suspected contaminants. If the wells are to be sampled for gasoline or other lighter-than-water liquids, the wells should be built with screens at the top of the water table to collect floating contaminants. However, if the contaminants are believed to be chlorinated solvents or other "sinkers" that settle at the bottom of an aquifer, the wells must be designed to allow sampling from the lower portion of the aquifer.

If groundwater contamination is confirmed, additional wells will have to be installed to determine the extent of the contamination and the direction of groundwater flow. The groundwater flow can be particularly important because the contamination may be flowing onto the site from an adjacent property.

As with the Phase I report, the environmental consultant should first communicate the results of the investigation orally and then prepare a draft report for review by the lawyer.

Delineating the extent of soil and groundwater contamination can be extremely costly, especially for transactions in the $1 million to $10 million range. Necessary sampling and analyses to understand the material liabilities may make some deals economically unviable. However, performing the work in stages and understanding the regulatory requirements can control the costs of a Phase II investigation.

American Society for Testing and Materials Standards for Due Diligence

The two ASTM standards for conducting environmental site assessments essentially split the traditional Phase I approach into two separate tasks. The first standard is known as a Transaction Screen (E 1528), which is a limited review that is based on the results of a questionnaire completed by an owner/operator of a facility, a cursory site visit based on the responses provided in the questionnaire, and a limited review of government records. The second standard, the Phase I Environmental Site Assessment (E 1527), is a more extensive examination that is similar to the Phase I approach discussed earlier. The Transaction Screen may be a useful device for deciding which sites to investigate in a multi-parcel transaction, but it is at best an issue-identifying device and should not be used in lieu of a full-fledged Phase I investigation. These standards are available for purchase at <www.astm.org/cgi-bin/SoftCart.exe/DATABASE.CART/PAGES/E1528.htm?L+mys tore+jyna7786+964753766> and <www.astm.org/cgi-bin/SoftCart.exe/DATABASE.CART/PAGES/E1527.htm?L+mys tore+jyna7786+964753501>, respectively.

While the ASTM standards are useful to the extent that they provide the regulated community with consistent definitions, for a number of reasons the standards fail to achieve their objective of creating uniform procedures for performing environmental due diligence.

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Perhaps the major flaw of the ASTM standards is that they still determine "appropriate inquiry" on a case-by-case basis, because the ASTM attempted to balance the need for obtaining information about commercial properties against the cost and time involved in obtaining these data. As a result, the level of appropriate inquiry varies depending on the nature of the transaction and the kinds of properties involved in the transaction.

Furthermore, ASTM practices continue to give parties to a transaction too much discretion in developing the scope of due diligence. For example, a seller who is not concerned about qualifying as an innocent purchaser may be willing to perform an ESA that will fall below that standard established for "an appropriate inquiry." Purchasers should not blindly rely on environmental audits based on the ASTM standards. Instead, these parties should independently review the scope of work to determine whether the investigation was adequately designed to assess conditions at a particular site. Undoubtedly, users will want to consider scopes of work that go beyond the ASTM requirements. One of the important changes to the ASTM 1528 standard is the requirement that the Phase I report provide sufficient documentation to allow an independent third party to recreate the process and arrive at the same conclusions. This could eliminate the need to perform duplicative site assessments for Phase I ESAs that are less than a year old.

Moreover, both the Transaction Screen and the ESA are required to identify only "recognized environmental conditions." While the definition of this term includes the presence of hazardous substances indicating that a release might have occurred in the past, it is not intended to include *de minimis* conditions that do not present a material risk of harm to public health or the environment and that generally would not result in any enforcement action by government agencies. This definition may not necessarily comport with requirements of various state cleanup and reporting laws. In addition, it is difficult to predict whether a particular level of contamination would set off an enforcement action. *De minimis* concentrations of hazardous substances

might trigger enforcement actions if there are environmentally sensitive areas or local drinking water wells or if the site is located in a residential community. It is preferable to tie the condition to state cleanup levels.

Another major weakness is the kind of information that owners or operators of facilities are required to disclose. The person answering the Transaction Screen is required to provide only information in their actual possession, not to locate information not in their possession. Likewise, the investigator is not required to conduct an exhaustive search of company records but simply to review information that is "reasonably ascertainable" or "practically reviewable." Reasonably ascertainable information is data that may be obtained "within reasonable time and cost constraints," while information that is practically reviewable refers to information that does not require extraordinary analysis. The ASTM suggested that records that are sorted or filed according to limited geographic areas would be considered practically reviewable, and large databases that are not organized by zip code or other geographic designation would not.

Another illustration of the limited nature of the ASTM standards is that the only source of physical information about the site that the investigator is required to examine is the USGS topographic map. The ASTM leaves other sources describing groundwater, soils, and geology to the discretion of the investigator.

For past uses of the property, the investigator is required to describe only those past uses or conditions that are visually or physically observable during the site reconnaissance or that are identified from reasonably ascertainable records. This leaves a lot of wiggle room for parties who are not interested in uncovering information about prior practices at a site.

The recent trend toward selling corporate assets through a bidding process has only heightened the importance of environmental due diligence.

The recent trend toward selling corporate assets through a bidding process has only heightened the importance of environmental due diligence. Sellers usually provide bidders with a form contract with little or no contractual protection for environmental liabilities, and bidders generally do not have much leverage to negotiate acceptable environmental representations, warranties or indemnities. Under such circumstances, it is imperative that purchasers fully investigate the environmental liabilities associated with the assets and take those liabilities into account when preparing their bid offer.

On the other hand, sophisticated purchasers may be able to use the due diligence process to their advantage in the bidding process. In the past, most environmental agencies developed cleanup standards based on the assumption that the property would be used for residential uses, even if the property was an industrial or commercial site. Now, however, many states have adopted risk-based approaches to cleanups in which the cleanup standard is based on the actual use of the property. Under this approach, states may allow higher levels of contamination to remain at a site or not require treatment of groundwater if it is not used for drinking water. This results in less-expensive cleanups. If purchasers develop sufficient information during their due diligence, they may be able to use environmental cost accounting techniques to develop a range of cost estimates using probability analysis and a discounted cash flow approach instead of estimating reserves. Using sophisticated environmental cost accounting, a bidder can determine that the environmental liabilities are not as high as anticipated and use the cost savings to increase the bid offer.

Top Ten Due Diligence Mistakes

Finally, many things can go wrong during due diligence. Here is a classic list of mistakes to look for:

- Relying on "commodity-style" reports. The environmental consulting business is very competitive, with many firms bidding on projects offering $1,500 to $2,000 per site. Prospective purchasers should be wary of these so-called commodity-style site assessments. They generally consist of a desktop records review and a cursory inspection of the premises—often by an inexperienced employee who may not be familiar with industrial operations. The reports may appear to be comprehensive because of thick appendices that contain database searches, but do not be fooled. The reports are actually sketchy on substance, highly unreliable, and often poorly written, informing the reader about only what the consultant found, not what the consultant failed to consider. Thus, it is difficult to determine whether a site investigation was sufficiently comprehensive. Indeed, a recent government study suggested that more than 70 percent of these "commodity-style" Phase I reports failed to discover site contamination.
- Relying too much on representations and warranties. Purchasers should not give in to the temptation to rely on representations and warranties in lieu of due diligence to save investigation costs. Representations or warranties should be viewed as a starting point to help purchasers identify possible environmental issues and shape the due diligence. The nature of the representations and warranties that a seller is willing to give may also provide the purchaser with a sense of the seller's attitude toward environmental compliance.
- . Not allowing sufficient time. Do not expect that environmental due diligence can be performed the day

before the closing. Purchasers should give themselves at least a month to adequately investigate the environmental issues associated with a business; additional time may be needed for multisite transactions involving a manufacturing operation. Although a Phase I ESA can generally be conducted in two weeks, a Phase II ESA usually takes a month or longer because samples must be sent to a laboratory for analysis. If a deal is time pressured, consultants can use field equipment that provides real-time data for screening purposes and can request expedited laboratory analysis. (Keep in mind this will substantially add to the analytical costs.) Purchasers should also try to do as much investigation work as possible once the equipment is available, rather than limiting sampling because of initial cost concerns. If the team and equipment must return to a site, remobilization costs can be significant.

- Not obtaining sufficient historical information. Commodity-style reports often skimp on time-consuming and labor-intensive historical investigations, which involve reviewing local records and interviewing local government officials. However, historical information is extremely important for older facilities because they change considerably over time; evidence of past improper disposal may no longer be obvious.
- Failing to focus on former facilities. Do not focus only on facilities the company currently owns or operates. Because courts are increasingly willing to impose liability on successor corporations, it is important to determine what facilities a company may have operated or owned in the past. It is possible the seller may have: contractually assumed environmental liabilities associated with previous assets; agreed to indemnify prior owners or operators; or incurred liabilities by operation of law. It is not uncommon for courts to rule that contracts executed prior to the enactment of CERCLA nevertheless allocate CERCLA liability. Thus, it is important also to review contracts transferring the assets or properties from the past.
- Failing to review disposal facilities. It is also important to identify facilities that the company presently uses to dispose its wastes as well as facilities that may have been used in the past, including those that may have been used by discontinued units or by operations that were sold. Once these facilities have been identified, a database search should be done to determine whether CERCLA cleanups would likely be required at those facilities.
- Relying on old audits. Do not rely on audits older than six months; conditions may have changed or the audits may not have been comprehensive. To save costs, a purchaser can consider ordering a rundown from the same consultant, to determine whether anything at the facility has changed. If so, another audit is advised.
- Relying on seller's audits. For the same reason, the buyer should not rely on audits provided by a seller. Reliance on due diligence performed by another party is not considered an "appropriate inquiry." Nevertheless, if a buyer is going to rely on environmental due diligence provided by a seller, the scope of work should be reviewed to ensure that the investigation would cover all of the areas the buyer wants examined. Without reviewing the SOW, it may be difficult to determine whether a particular environmental issue was not discussed in a report because it was not examined.
- Improperly estimating liabilities. Estimate environmental liabilities using actual cleanup standards allowed by the state environmental agency to make sure that they are not over- or underinflated. When a cleanup escrow is established, the buyer has incentive to ensure that the escrow is depleted so a seller should ensure that the most cost-effective cleanup allowable by the state is used. For example, if a state allows residual contamination to remain at a site provided a deed restriction is placed on the property, the cleanup estimate should not be based on the cost of excavating and disposing of contaminated soil at an off-site facility.
- Relying solely on bid data rooms. Many sellers offering assets in bids want to limit a buyer's due diligence to the documentation provided in the data room. Buyers should review all documents in the actual or constructive possession of the seller relating to environmental issues, request access to environmental managers, and schedule inspections of the seller's facilities.

Minimizing Risks

(Continued from page 87)

ters deemed "material" by management at the time of the filing are typically disclosed. Those matters that at the time of the disclosure do not appear to management to be material, but may in fact turn out to be material, are not disclosed. In addition, any matters that occur, or are discovered subsequent to the filing, are not included in the disclosure.

Environmental Database Searches

Commercial on-line environmental databases are publicly available and can be accessed through a variety of commercial providers of environmental and legal research materials. These databases contain information obtained from federal and state regulatory files. More specifically, the databases include

- the current version of the National Priorities List (NPL) (i.e., the list of the sites designated as the most contaminated sites in the U.S.) and names of persons or companies that have been named as PRPs at the sites;
- the Comprehensive Environmental Response, Compensation, and Liability Information System (CERCLIS) list, which is a list of sites where hazardous substances have been released and are being evaluated