a few things you should know about…

ENVIRONMENTAL DILIGENCE IN BUSINESS AND REAL PROPERTY TRANSACTIONS

This edition of *A Few Things You Should Know* concerns environmental diligence in business and real property transactions. We discuss why and how to conduct environmental diligence and related environmental issues to consider in business and real property transactions.

- ## WHY CONDUCT ENVIRONMENTAL DILIGENCE?

  Environmental due diligence serves a variety of purposes. In a buy-side transaction, one primary purpose is to benefit from important defenses to environmental liability by following the necessary and proper procedures. In addition, environmental diligence helps you understand what you are buying or leasing, and it gives you information to allocate risk and negotiate the terms of the transaction.

- ## WHAT IS THE DEFENSE TO SUPERFUND LIABILITY?

  The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA, or Superfund) is a federal environmental statute that establishes a liability scheme for determining who can be held accountable for contamination. It is the most significant tool for holding property owners or tenants liable for cleanup of "hazardous substances" on or under real property. Many states have their own versions of Superfund and, in most cases, the liability scheme is similar to the federal law. Note that CERCLA only addresses contaminated property. It does not address environmental compliance liability, which is briefly discussed below.

  CERCLA imposes strict, retroactive, and joint and/or several liability on, among others, current and past owners or operators of contaminated property. CERCLA contains very limited defenses, including two defenses that are important in a transactional context. First, parties that qualify as "innocent purchasers" can be exempt from liability if, among other things, they did not know or have reason to know of contamination of property when it was acquired (meaning they took "all appropriate inquiry" consistent with good commercial practices). 42 U.S.C. § 9601(35). This exemption can be applied to a contiguous property owner that otherwise could be liable due to contamination that has migrated onto or under its property. Second, CERCLA contains a defense for "bona fide prospective purchasers" or "BFPPs," where the new owner or operator did not contribute to the contamination and, among other requirements, made all appropriate inquiries regarding environmental conditions on the property prior to acquisition that are consistent with good commercial or customary practice. 42 U.S.C. § 9601(40). The BFPP defense also has been applied to lessees that meet the statutory requirements.

  The U.S. Environmental Protection Agency (EPA) has issued regulations detailing what constitutes "all appropriate inquiry," and these requirements are set forth at 40 C.F.R. Part 312. All appropriate inquiry requires the performance of a Phase I environmental evaluation that meets the requirements of the regulation, as discussed further below.

  Unfortunately, BFPP and innocent purchaser defenses are not typically available in a transaction structured as an equity purchase or a merger. In an equity purchase (whether direct or in the form of a triangular merger), the target company continues to exist following the closing, with all of its pre-closing liabilities, including environmental liabilities (or such liabilities are assumed by the buyer's merger sub). If the target company is merged directly into the buyer, then, as the successor company, the buyer inherits the pre-closing liabilities of the target. This result often causes

parties to structure a deal with significant environmental concerns as an asset purchase so that the purchaser can take advantage of BFPP and innocent purchaser defenses.

- OTHER REASONS FOR CONDUCTING ENVIRONMENTAL DILIGENCE

  The liability defenses are not the only reasons parties conduct diligence. In fact, there are situations where it is clear that a buyer or lessee will not be eligible for the defense to liability, yet still chooses to perform a Phase I (and maybe even a Phase II, which may include soil, groundwater or air sampling) environmental assessment. These evaluations can help a party understand what it is buying or leasing, what ongoing environmental obligations may exist, and whether to move forward with a transaction at all. In addition, environmental diligence, like any diligence, helps parties allocate risks through assigning responsibility for environmental compliance (e.g., in a lease), indemnification language or obtaining insurance. Insurance carriers typically will require environmental diligence in order to issue policies.

- WHAT IS THE APPROPRIATE SCOPE OF ENVIRONMENTAL DILIGENCE?

  The appropriate scope of environmental diligence will vary depending upon many factors, including the type of industry, its location, its specific operations, the risk tolerance of the buyer and the transaction itself. Environmental diligence can take many forms, including Phase I and Phase II environmental assessments, desktop reviews, compliance reviews and documentation reviews.

- PHASE I ASSESSMENT

  A Phase I assessment can be an important component of an environmental diligence review for several reasons. To satisfy the elements of the Superfund defense, the Phase I must meet certain criteria outlined in the EPA rule. A Phase I consists of a documentation review, a questionnaire to be completed by the "user" of the Phase I, and a site visit. The purpose of the Phase I is to identify "recognized environmental conditions," or "RECs." Phase I assessments also consider historical RECs (i.e., old issues that have been completely addressed) and controlled RECs (i.e., old issues that have been resolved but require some type of condition such as a land use restriction). Importantly, even if a party qualifies for BFPP status, some ongoing obligations with regard to existing contamination may be required (e.g., to prevent offsite migration of historic hazardous substances).

  To qualify under the statutory defenses, a Phase I can be no older than six months. If the report is between six months and one year old, it can be updated with some additional steps, including a new site visit. Under the EPA rule, any report that is older than one year is considered too old to be updated, and a new assessment must be conducted to meet the requirements. That does not mean that an older Phase I report is useless. An older Phase I can still help parties understand the nature of the business and, for targets that are not in environmentally sensitive industries or that are located on property that is not likely to be contaminated, the parties may be comfortable with the risk involved and determine that a new Phase I is not appropriate. An older Phase I also can help to identify environmental issues for further inquiry or investigation.

  Note that a Phase I assessment only considers whether a property is impacted by releases or threats of releases of contamination. It does not certify that a property is clean. It does not involve physical testing or sampling. In addition, a Phase I does not evaluate compliance or other property risks such as asbestos, lead paint, or the presence of wetlands on the property, among other things. Also, as noted above, a Phase I evaluation does not provide protection from CERCLA liability in a stock purchase.

  A typical time frame for conducting a Phase I assessment is approximately two to four weeks, depending upon site visit schedule and access to local/state agency records.

- PHASE II ASSESSMENT

  If a Phase I identifies a REC, the consultant may recommend a Phase II evaluation to determine whether the property has been impacted. A Phase II involves soil, groundwater or air testing, and often a work plan is prepared and approved in advance. A Phase II can be limited in scope as appropriate to the property risks and past and planned future usage. Phase II assessments can provide a current snapshot of the potential level of contaminants and also act as a baseline for new owners, operators or lessees. A Phase II will require property access and sometimes parties even will negotiate separate site access agreements for this purpose. As for timing, a Phase II can take from as short as a month to several months, depending on the scope and other factors.

- DOCUMENTATION REVIEW

  Environmental diligence also includes review of documentation. We generally accomplish this through diligence requests and often the target posts this information in a data site that is accessible by the buyer's diligence team. Perkins Coie uses standard requests when seeking environmental diligence materials. These requests are broad and cover a variety of items such as environmental permits and registrations, environmental reporting (such as monitoring reports), notices of violation, any prior Phase Is, Phase IIs or compliance audits, and correspondence with regulatory agencies, among others. Requests may be tailored to address specific issues related to an industry or even a particular target. When representing the buyer or lessee, we may send supplemental requests based on a target's initial responses.

- ENVIRONMENTAL COMPLIANCE ASSESSMENT

  Depending on the nature of the business and the type of transaction, sometimes a compliance assessment is appropriate. Such an assessment will evaluate whether a business is in compliance with environmental (and often health and safety) laws. A compliance assessment can be limited—basically to provide a sense of any major red flags—or it can be an extensive audit. Parties may need to negotiate how to handle the results of an audit if, for example, a violation is discovered that is required to be reported under applicable law. When representing a buyer, it is sometimes appropriate to conduct a more thorough post-closing compliance audit with new management. Some purchasers elect to take advantage of federal or state self-disclosure policies, which give new owners time to review and correct noncompliance to avoid penalties.

  A limited compliance assessment can typically take two to four weeks and often is conducted by the same consultants and at the same time as a Phase I. A full compliance assessment is much more involved and can take a couple of months or longer.

- DESKTOP REVIEW

  Many clients ask about "desktop" reviews. A desktop review is essentially a review of documentation (often the same documentation that a consultant would review in a Phase I) but with no site visit and no user questionnaire—both of which are required for a full Phase I. Because there is no site visit, a desktop review is quicker and less expensive than a Phase I. However, a desktop review is not sufficient to provide a defense to Superfund or state cleanup liability. If a property involves hazardous substance management or there is any reason to believe that the property could be impacted with contamination, a desktop review is probably not appropriate. Even in a stock transaction, where the buyer will not benefit from any environmental liability defense, if the business uses hazardous substances or if there are known environmental issues, a desktop review likely is not the appropriate diligence tool. On the other hand, a desktop review may be useful where environmental concerns are not anticipated and the goal is simply to identify red flags for potential further review. For example, a desktop review may be appropriate for a property that is used as an office and that does not have any history of being used for manufacturing, where there is no indication that neighboring properties are or have been used for manufacturing, and generally where there appears to be little risk of environmental cleanup liability.

- SALE VS. LEASE
  The environmental liabilities described above apply to both "owners" and "operators" of contaminated properties. Generally, lessees are considered "operators" and therefore simply being a lessee does not protect a party from liability. In addition, if a property is contaminated through prior operations, it will be important to establish a baseline to protect a new lessee from liability for contamination that it did not cause. Thus, it is typically appropriate to conduct the same level of environmental diligence for a lessee as it is for a purchaser. Note that in a lease situation, the parties may be able to negotiate the lease agreement to allocate liability for preexisting contamination to the owner/landlord.

- DUTY TO NOTIFY/REPORT FINDINGS
  Many states have laws or regulations requiring reporting of the discovery of contamination. These reporting obligations vary greatly from state to state and may depend on the type of substance discovered. For example, in California, a prospective purchaser does not have any duty to report the discovery of contamination. In other states, such as Missouri, a reporting obligation may apply to prospective purchasers. Potential state reporting requirements should be carefully considered whenever environmental diligence reveals contamination.

- TRANSACTION-TRIGGERED LAWS
  Certain states require more extensive diligence steps and notification to buyers/lessees. Key examples include New Jersey's Industrial Site Recovery Act (ISRA), Connecticut's Transfer Act and Michigan's Baseline Environmental Assessment requirements, among others. Some of these requirements can add significant lead time to a transaction and therefore should be evaluated very early in the transaction.

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A FEW THINGS YOU SHOULD KNOW is a periodic publication of the Mergers & Acquisitions practice group of Perkins Coie LLP. Each edition covers a discrete topic related to M&A, including identifying key issues to be addressed and related market trends. We also share our experience-based insight into current approaches to resolving common deal issues. *A Few Things You Should Know* is intended as a high-level issue-spotting guide and quick-reference resource for buyers, sellers and their professional advisors. Please contact the Perkins Coie LLP attorney listed above for more information.