

Assessing & Allocating Environmental Risk in Acquisitions

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Negotiating Strategies

Uncertainty underlies negotiating positions in all transactions. Limiting and allocating exposure to environmental risk increase the likelihood of coming to agreement and closing the deal. Typically, the parties identify environmental risks early on, during the due diligence period. After the buyer completes due diligence, the parties negotiate various options to mitigate and allocate risk. Options range from excluding facilities that have contamination or non-compliance issues to using risk management tools. These tools include addressing the contamination or compliance issues prior to closing, allocating liability in the terms of the deal, and using statutory programs to address environmental conditions and avoid liability on statutory grounds.

Identifying and Assessing Environmental Risks

Scope of due diligence. Environmental risk assessment takes many forms, often driven by the level of inquiry in a particular transaction. The level of inquiry depends on such factors as risk tolerance, deal structure, timeline of the transaction, and the number and environmental complexity of the properties and assets. For mergers and stock purchase transactions, the buyer succeeds to the liabilities of the acquired entity or acquires exposure to liabilities based on stock ownership. Accordingly, business combinations may justify a higher level of review than asset acquisitions. Mergers often pose special challenges due to confidentiality restrictions, the speed of negotiations and limited access to persons with knowledge of environmental due diligence. Asset purchases involve deal-specific issues, depending on the mix of assets.

Identifying potential releases. The American Society for Testing Materials (ASTM) Phase I—the primary form of environmental risk assessment—may not be practical in some cases and may not be sufficient in others. The goal of an ASTM Phase I is to identify conditions that indicate releases or potential releases of hazardous

substances. However, environmental risk goes beyond releases and contamination to compliance and development issues, which are not covered by a Phase I assessment.

Phase I reports. ASTM Phase I reports may also benefit the buyer by setting up defenses to Comprehensive Environmental Response, Compensation and Liability Act, or CERCLA. However, CERCLA defenses do not offer protection from other federal statutes such as RCRA (the Resource Conservation and Recovery Act, the principal federal law governing the disposal of solid waste and hazardous waste) and may not be sufficient to set up defenses to state laws or common law theories such as trespass or nuisance. To determine the extent of an environmental assessment, the parties evaluate potential risks, benefits and specific aspects of the deal, including any requirements imposed by third parties such as lenders.

Analyzing merits and limits of the ASTM Phase I:

- *Practicality:* Is an ASTM Phase I impractical? The buyer might elect to modify a Phase I for the purchase of a midstream energy company with many miles of pipeline to avoid reviewing all records from within 1/4 to 1/2 mile of the entire pipeline.
- *Scope:* Is an ASTM Phase I too narrow? A power plant may not have many issues with onsite contamination but may have looming environmental regulation which will make future operations more difficult and expensive. An ASTM Phase I might be helpful, but the buyer might elect to focus on permits and regulatory requirements.
- *Contractual indemnities:* Are there agreements in effect that govern environmental liabilities? An old refinery or chemical plant might have legacy environmental issues that are already handled under separate agreements, and a Phase I would identify these known legacy issues. Under these circumstances, however, a buyer might

prefer to focus on the acceptability of the related agreements and indemnities and other operational issues rather than the traditional Phase I information.

- *Priorities and timing:* Are issues other than releases more material or important to the deal? If a developer is purchasing greenfield real estate with wetlands onsite, the developer might focus its attention on completing the wetlands permitting process in a timely manner rather than focus on the Phase I.

Environmental risks associated with acquisitions

Environmental risks associated with transactions generally fall into three categories, as further described below: 1) liability for contamination, 2) compliance and 3) development.

1) Liability for contamination

Sources of liability: Liability for contamination can arise from conditions on the property as well as conditions that cause contamination offsite, for example, on adjacent properties or in water supplies. Liability can also arise from improper handling and disposal of material at offsite locations. Property contamination can result in strict liability for the seller and buyer, and deal-breaking expenses for all of the costs of a response action from investigation, removal and remediation costs to government oversight costs, alternative water supplies and damages assessed for harming natural resources.

Strict liability for property contamination under federal law: CERCLA is the federal strict liability statute most commonly associated with liability for property contamination. Current owners, past owners at the time of a release, arrangers and operators may all be held liable under the statute. Under the arranger liability provision, liability can attach for contamination at other property where material was shipped for disposal.

Defenses under CERCLA: CERCLA includes several defenses to liability: 1) the innocent landowner, 2) bona fide prospective purchaser and 3) the contiguous property owner. All of these defenses require that “All Appropriate Inquiry” (AAI standards) be met. In addition, statutorily required continuing obligations must be satisfied, such as the prevention of continuing or future releases. AAI standards of due diligence are defined by EPA in regulations at 40 CFR Part 312. ASTM Standard E1527-05 was designed to meet AAI standards for due diligence in the form of an ASTM compliant Phase I. In order to obtain the statutory benefits of meeting AAI standards, the buyer should confirm that the Phase I assessment performed complies with ASTM requirements.

Further testing—Phase II: If contamination appears to be present on the property, the buyer will often consider a Phase II. A Phase II includes invasive testing, best done with the benefit of an agreement that includes the terms of access and testing. If the property is leased, there may be issues with invasive testing. Property owners themselves may also be sensitive to testing as invasive procedures may discover additional issues that may increase potential liability and remediation obligations for the owner.

Alternatives to invasive testing: The parties may consider other options if the Phase I indicates potential releases at the property and testing is not authorized. Offsite investigations such as testing in nearby rights of way or more intensive reviews of public records and interviews can help to identify potential risks without conducting a Phase II. Other provisions of the transaction agreements can also address potential future liability, as described below.

Basics of environmental assessment:

- *Availability of defenses:* Should due diligence be performed to meet requirements that help set up defenses to liability?

- *Requirements of Phase I:* If the Phase I is being used to set up a defense to CERCLA, does it meet the ASTM Standard E1527-05 requirements?
- *Shipments and offsite exposure:* Do the operations involve the shipment of transformers, chemicals, hazardous waste or batteries? These shipments often result in offsite exposure.
- *Terms of access:* Will an Access Agreement be required? What terms should be covered?
- *Non-ASTM considerations:* Should the Phase I be expanded to include other environmental business risks or compliance issues?

Practice tip—beyond Phase I: Recent cases suggest that more than a Phase I may be required to establish the bona fide prospective purchaser defense. A buyer may consider what additional steps a prudent person would take under the circumstances, such as the exercise of appropriate care with respect to the hazardous substances found during the environmental assessment.

Practice tip—legal review of draft report: Phase I reports containing recommendations which are not followed or undertaken can weaken defenses that may be available in the future. In addition, Phase I reports are typically available to future potential purchasers, and a legal review of the draft report prior to finalization can be prudent.

2) Compliance

The ASTM standards for Phase I investigations do not require a review of compliance. However, the consultant can perform a compliance review concurrently with the Phase I. A buyer can include compliance inquiries along with interviews of plant personnel and the review of company documents. Depending on risk tolerance levels and the nature of the deal, a buyer may also rely on representations and warranties in the transaction documents.

Basics of Compliance:

- *Compliance with permits:* Determine whether all permits necessary to operate are in place and whether the facility can operate in compliance with the terms of the permits.
- *Permit renewals:* Review permit renewal dates. Renewals can be time-consuming and expensive (and sometimes uncertain), especially if a new company does not have access to all of the knowledge and documentation of a prior company.
- *Potential limitations on operations:* Existing and proposed environmental rules may restrict future operating parameters and productivity. Rules covering air emissions, including greenhouse gases, and wastewater discharge limitations require particular scrutiny.
- *Potential violations:* Review existing and threatened compliance issues. Potential violations, orders and citations can result in penalties, including future stipulated penalties, limits on operations and requirements to install and monitor expensive controls.

If changes to operations are planned, the buyer should ask the following permitting questions:

- Can amendments be obtained within the timeline required?
- Will proposed changes trigger more stringent requirements?
- Will emissions credits be required, and how can credits be obtained?
- As a matter of corporate policy, does the buyer seek to exceed permitting standards?

Practice tip—consents and transfers: Environmental permits cannot be unilaterally assigned by a company. Usually, there is at least a ministerial mechanism for agency approval before the transfer of the permit, and

the parties typically agree to cooperate in seeking permits. Some transfers must be initiated before closing and others may be initiated after closing. If not properly factored into the timeline of the transaction, the timing of permit transfers may delay closing.

3) Development

If the buyer expects to develop a property or modify a footprint during or after the deal, other environmental programs may come into play.

Basics of development:

- *Wetlands*: If there are wetlands on the property, dredging and filling cannot occur without a general permit, nationwide permit or individual permit. Obtaining an individual permit can take a year or more.
- *Special designations*: Migratory birds, endangered species, and historical and archeological designations can impact development. Solar and wind development projects in particular may need to be redesigned to meet programmatic requirements or may face delays and hearings related to these issues.
- *Environmental impacts*: A NEPA review under the National Environmental Policy Act, potentially including an environmental impact statement, may be required in deals that involve federal action such as federal funding or the issuance of a permit by a federal agency. NEPA reviews can delay the closing of the deal and require public notice and the opportunity for public comment.

Practice tip—specialists: Developmental issues often require specialized environmental consultants. Most Phase I consultants are engineers or geologists. Migratory birds, endangered species and wetlands reviews require training in biology. Historical and archeological surveys also require specialists.

Allocation of Environmental Risk

Risk allocation issues differ for the buyer and seller. Risk allocation also differs depending on the structure of the transaction. Asset purchase transactions generally allow greater flexibility in allocating environmental risks. Below are some common environmental risks and tools.

1) Indemnity provisions

Indemnity provisions allocate risk and often include specific language related to existing or potential future environmental liabilities. If the target has significant environmental risks, the parties may negotiate a specific indemnity for potential future environmental liability. Indemnities can include provisions to divide up environmental responsibility, such as:

- *Adjustment over indemnity period:* The seller's indemnification obligations may decrease over time by specified percentages or by specified dollar amounts.
- *Survival of the seller's obligations:* The seller's indemnification obligations may expire at the end of a particular time period or may decrease over a variety of specified time periods.
- *Basket:* A "basket," or dollar threshold, for damages may need to be met before seller's indemnification obligations are triggered.
- *Deductible or threshold:* The basket may be structured as a true deductible or as a "tipping basket," which allows buyer to recover damages from dollar one.
- *Cap:* Seller's indemnification obligations may be capped, may decrease over time and may be different for known contamination versus potential third-party or governmental claims.

- *Known liabilities:* A seller's indemnity may also be limited to liabilities that are identified in a Phase II environmental site assessment report and require remediation or corrective action under applicable environmental laws.
- *Exclusive remedy:* The parties may agree that the terms of the environmental indemnity are the exclusive remedies of the parties for environmental liabilities.
- *Assignment:* The seller's indemnification obligations may or may not be assignable by the buyer or may be assignable only if the buyer sells substantially all of its assets.

Depending on the transaction and the associated risks, the parties can negotiate customized provisions to deal with known and unknown environmental liabilities.

If the transaction is a public company merger, or the seller is in bankruptcy or otherwise in distress, the structure of the transaction does not allow for post-closing indemnities. In these transactions, the acquiring company relies on its pre-closing due diligence and carefully drafted conditions to closing, such as remediation or absence of a material adverse change. In the case of a bankruptcy, a liquidating trust can be formed to provide indemnities. Insurance can be used in lieu of an indemnity or to supplement indemnities.

In private company transactions, an escrow agreement can provide a mechanism to fund existing or potential future environmental liabilities. Escrow arrangements may offer particular comfort to a buyer if 1) the seller is selling substantially all of its assets and will likely distribute the sales proceeds and dissolve, 2) the future financial viability of the seller is otherwise suspect or 3) the seller is owned by individuals of uncertain creditworthiness (as opposed to a company that will continue to operate and generate cash post-closing).

2) Insurance

Two primary forms of environmental insurance can be used to address environmental risks, with the allocation of costs to be negotiated between the parties: pollution legal liability (known as PLL) and cost cap. Pollution legal liability insurance covers potential contamination risks for property damage and bodily injury. PLL insurance typically requires a significant self-insured retention, and premiums must be paid in advance. PLL insurance is a “claims made” form of policy which means a claim must be made during the term of the policy. Policies often extend for ten-year terms but may be 5- or up to 20-year terms. Cost cap insurance is often used for known contamination. The expected cleanup cost is assessed and the insurance covers additional sums.

Practice tip—expansion of coverage after remediation: In cases of known contamination, PLL policies can often be manuscripted to add a condition that coverage will be expanded after remediation is complete.

3) Remediation options

Remediation standards. The parties can address known contamination by requiring the seller to remediate to some predetermined level prior to the sale or for the seller to retain obligations associated with remediation. Remediation arrangements require careful consideration of potential future issues, including cooperation between the parties and failure to achieve cleanup objectives. If the seller retains responsibility for the cleanup after closing, the agreement should address access issues as well as the expected standard for cleanup. If the seller will be allowed to meet a cleanup standard that would require deed restrictions on the property, the parties should define the kind of restrictions.

Baseline. The parties may also consider developing a baseline for remediation. A baseline can establish existing versus potential future contamination, and the parties can allocate responsibilities for cleanup accordingly. A baseline offers important benefits in circumstances where past and future contamination might mix.

Sale of property. If known contamination requires long-term cleanup, there are companies that purchase contaminated property and assume the associated liability. Transactions that do not center around the contaminated property may benefit from this type of arrangement.

4) Other transactional mechanisms

Many provisions can be negotiated to allocate environmental risks. Specific examples include:

- *Conditions to closing:* Closing conditions can include a “walk right” for the buyer if the buyer is not satisfied with environmental due diligence or if the seller does not meet some specified level of cleanup or removal of particular concerns, such as underground storage tanks.
- *Asset purchase agreements—seller-retained liabilities:* The language should clearly state how liability for environmental conditions will be allocated, including conditions arising before and after closing that relate to contamination existing at the time of closing. The seller may agree to retain liability for a particular asset that is excluded from the purchase agreement. However, if the asset has environmental liabilities and the buyer is purchasing substantially all of the seller’s assets, then the buyer should give careful consideration to the potential claims of successor liability by third parties or governmental authorities and potential cleanup liabilities that might be imposed on the buyer as a successor. Much of this analysis depends upon state law and the application of CERCLA and other federal statutes discussed above as well as various potentially available defenses to these claims.
- *Price reductions or escrows:* Price adjustments and escrow mechanisms cover potential future costs and require the parties to agree as to the cost of remediation. Price adjustments generally

entail a lengthy process of investigation and negotiation but may offer a useful tool if the parties seek to avoid disputes over post-closing indemnification obligations.

- *“No dig” provisions:* A seller of industrial property can address discovery of contamination through the use of “no dig” provisions, which release the seller from its indemnification obligations if contamination is discovered during the course of certain buyer actions.

5) Agency programs

The parties may also mitigate environmental risk using agency documentation and programs such as the following:

- *Voluntary cleanup:* In many states, including Texas, prospective purchasers can obtain protection from future liability through a Voluntary Cleanup Program. The property typically must be entered into the program prior to closing.
- *Prospective purchase agreements:* EPA and some states sometimes agree to review the issues and enter into prospective purchaser agreements. These programs have become less popular after the advent of AAI defenses. Timing of government response may rule out purchaser agreements from a practical standpoint.
- *Audits.* Many states and the EPA have audit privileges that can be used to limit potential liability for compliance issues. Audits performed after closing may still afford protection.
- *Innocent landowner provisions.* If contamination can be shown to come from adjacent property, the parties may consider statutory protections such as the Innocent Landowner provisions of the Texas Solid Waste Disposal Act.

Overcoming Deal Breakers

Environmental risk and liability do not necessarily present a deal breaker. With the proper assessment of environmental risk, the parties may settle on a workable allocation of known and potential liabilities that allows the transaction to move forward.

A Modern Environmental Practice

The environmental movement has come a long way since Walden Pond. Activists no longer come clad in bell bottoms, but business suits. Green is no longer a color, but a movement. Sustainability is no longer a buzz word, but a requirement. The environment is big business. Companies across all industries are faced with concerns, requirements and potential liabilities ranging from government regulation and compliance to balancing sustainability with profitability.

At Andrews Kurth, we help our clients navigate the complexities of the modern environmental movement. Using a pragmatic and multi-disciplinary approach, we identify, address and mitigate the inevitable environmental issues and risks our clients encounter simply through the conduct of their business. We balance environmental sustainability with corporate sustainability. We think the definition of green includes profitability and longevity. And we think fostering growth should apply to more than just trees.

The Andrews Kurth Environmental Practice has:

- Full integration with other practice areas, including Energy, Corporate, Finance, Bankruptcy and Real Estate practice groups, to facilitate seamless management of issues that arise during transactions and find solutions to keep deals on closing track.
- Deep bench strength in environmental litigation, including landmark CERCLA and environmental indemnity cases.
- Environmental lawyers who are at the forefront of developments within the environmental regulatory framework and in the context of energy and non-energy sector transactions.
- Regularly advised on climate change-connected disclosure requirements for public companies mandated by Sarbanes-Oxley Act and the SEC, and addressed other concerns in corporate social responsibility.

- National experience appearing before the United States Environmental Protection Agency, both headquarters and at the regional level.

Now that is straight talk about environmental law. For more information about Andrews Kurth's Environmental Practice, or to learn more about our environmental attorneys, please visit our website at www.andrewskurth.com/practices-Environmental.html.



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Lisa's practice focuses on environmental, health and safety counseling, compliance and liability. She has extensive experience analyzing environmental, health and safety issues associated with corporate and securities matters and mergers and acquisitions, including Brownfield redevelopment. Lisa works with a broad array of industries from chemical and semiconductor companies to the full spectrum of energy companies from coal and oil and gas to renewables and clean fuels such as solar, wind and biomass projects. Lisa has experience in a wide range of associated matters including negotiation of environmental insurance policies and drafting securities disclosures for a wide range of industries. She has worked with industry associations and companies to address air, waste, water, wetlands, underground injection and toxics issues in permitting, enforcement and regulatory forums and has handled administrative proceedings before TCEQ, RRC, EPA, USACE and the GLO. She received her J.D. in 1987 from Texas Tech University School of Law, where she was Phi Delta Phi, and her B.A. from University of Vermont in 1979.



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