

Environmental Due Diligence and Risk Allocation

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MCLE Environmental Basics
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Relevant To A Broad Array of Transactions

- Purchase/sale of real estate
- Purchase/sale of ongoing business with real estate assets and/or environmentally sensitive operations
- Merger/stock acquisition

Environmental Due Diligence

Environmental Due Diligence is a Subset of Overall Due Diligence

- Purpose: Help client value assets and quantify risk as to individual matters and in the aggregate
- Sometimes handled exclusively by environmental lawyers from outset of transaction
- Sometimes the business lawyer kicks it off and then involves the environmental lawyer
- Given the plethora of laws (federal, state, and local) and the potentially high financial stakes, it's advisable to involve an environmental lawyer early on

Typical Environmental Due Diligence Queries for Real Estate Acquisition

- Soil, groundwater, surface water quality
- Building conditions that could endanger employees or require special maintenance
- Compliance with laws regulating use of wetlands, waterways, coastal areas, endangered species, and areas bordering rivers
- Location, status, and compliance of underground and aboveground storage tanks
- Compliance of septic system with Title 5 regulations
- State or federal liens against property
- Recorded property use restrictions



Real Estate Due Diligence (continued)

- Soil, groundwater, surface water quality
 - Check current and former uses of property
 - Think about associated waste streams
 - Check status of property in regulatory databases
 - Check existing reports
 - Hire consultant to do sampling
 - ASTM Standards for Phase I and II investigations

Real Estate Due Diligence (continued)

- Standards for Real Estate Phase I Assessments
 - ASTM E1527-2000 and E1527-2005
 - EPA Regulation of “All Appropriate Inquiry”
 - Final Rule in Effect as of 11/1/06
 - Promulgated at 40 CFR Part 312; *see* 70 Fed.Reg. 66070, <http://www.epa.gov/brownfields/regneg.htm>
 - Compliance with 1527E-2005 complies with AAI

Elements of AAI

- Inquiry by “Environmental Professional”
- Interviews with past and present owners/occupants
- Review of historical sources, such as aerial photographs
- Lien search
- Government records search
- Visual inspection of property and adjoining properties
- Defendant’s specialized knowledge
- Relationship of purchase price to clean value
- Commonly known information
- Obviousness of contamination

Real Estate Due Diligence (continued)

- Building conditions that pose potential dangers to employees or require special maintenance and/or handling in event of renovation or demolition
 - Asbestos (insulation, ceilings, floor tiles, roof, wallboard)
 - PCBs (light fixtures, electrical equipment, tiles, glazing and caulking compounds)
 - Radon
 - Lead Paint
 - Mold

Real Estate Due Diligence (continued)

- Construction Compliance - current and future
 - Massachusetts Environmental Policy Act
 - Wetlands Protection Act
 - Rivers Protection Act
 - Coastal Zone Management
 - Waterways Licensing
 - Endangered Species
 - Sewer connection and Septic systems
 - Local restrictions often stricter

Real Estate Due Diligence (continued)

- Liens and use restrictions
 - Federal superfund lien (and windfall lien provisions)
 - State lien under M.G.L. ch. 21E
 - Use restrictions recorded on deed (e.g., AUL, -- wetlands order of conditions, conservation or historic preservation restrictions)
- Tanks (underground and aboveground)
 - Condition and compliance

Business Acquisition Due Diligence

Acquisition of ongoing business raises additional questions if those business activities are regulated under environmental law

- Compliance with laws and permits
 - Have recent deadlines been met?
- What will it cost to meet upcoming deadlines or requirements
- Relationships with key regulators
 - Any threat of significant penalties or shut-down of operations?
- Status and magnitude of any contractual undertakings, if any, that will be passed on to buyer

Business Due Diligence (continued)

- Different than due diligence for real estate transactions
 - Potentially significant issues about trade secret and other proprietary information
 - Are any violations that are discovered subject to reporting? Who should report? – EPA Self-Disclosure Policy.
<http://www.epa.gov/compliance/incentives/auditing/2007-faqs.pdf>
 - Can buyer meet with regulators prior to closing? Opportunities for buyer to be “white knight”

Business Due Diligence (continued)

- Permits

- Types: air, water withdrawal, water discharge, stormwater, sewer/septic, recycling, flammables storage
- Transferability/expiration date
- Can be valuable assets if transferable and suitable for buyer
- Conditions (suitability for buyer's use)
- Notices of non-compliance/Enforcement actions

Business Due Diligence (continued)

- Overall compliance of operations
 - Audit reports/Self-monitoring reports (air, water, hazardous waste)
 - Notices of non-compliance/Administrative orders/Consent orders/Private Party Claims (21E)
 - OSHA violations/Workers' compensation claims
- Relationship with regulators
 - Tenor of correspondence
 - Patterns of non-compliance
 - Size of past penalties
 - Interviews

Merger/Stock Acquisition Due Diligence

- Evaluate potential risk associated with each previously-owned or operated property and past off-site waste disposal practices
- Evaluate inherited and assumed liabilities
 - You “get” more than meets the eye

Time Constraints in Due Diligence and Transactions

- Use of consultants to drill and sample is time-consuming
- Permit transfers/applications
 - Advance notice v. prior approval
 - Take time to process
 - May need to negotiate conditions
 - Some require hearings/public comment period
- Special legislation may require advance filing and other pre-closing activities
 - Industrial Site Recovery Act in New Jersey
 - Connecticut Transfer Act
 - Ch 61 (Agricultural/Forest Land) first refusal

Results of Due Diligence

- Establish baseline of information for:
 - Evaluating suitability of asset for its intended use
 - Evaluating risks
 - Defining costs
 - Securing Financing
 - Allocating liabilities between the parties
 - Negotiating indemnities and other contractual provisions
 - Obtaining insurance
 - Obtaining brownfields liability relief
- Occasionally deal breaker (but more often just blamed as a deal breaker)

Risk Allocation

Putting the Deal on Paper

- There is no single model that works for all situations
- Form documents are of limited use
- Understanding of risks and applicable law is key

What Does Seller Want?

- “As is” sale, with no contingencies
- No representation or warranty about anything
- Buyer releases seller for everything
- Buyer indemnifies seller for everything
- No deduction in price or hold-backs

What Does Buyer Want?

- Detailed representations and warranties (and not just limited to seller's "knowledge", with no "materiality" threshold)
- Seller releases buyer for everything
- Seller indemnifies buyer for everything
- Price reduced/escrow for liabilities
- Buyer's obligation to close is contingent on seller's remedial action
- Insurance policies

Common Risk Allocation Techniques

- Price reduction
 - Administrable, but crude
 - Works when there is little disagreement about the magnitude of the risk or problem

Common Risk Allocation Techniques (continued)

- Seller agrees to fix identified problems within a specified time (before or after closing)
 - Can be effective, but seller often loses incentive after the sale
 - Tension: Seller wants to control its money, but buyer wants to make sure seller doesn't cut corners
 - Make sure to provide with specificity what needs to be fixed and how (e.g., for a 21E clean-up, can an AUL be used?)
 - Caution: In MA, certain tax incentives favor buyer-financed clean-up (or at least clean-up by "innocent" party)

Common Risk Allocation Techniques (continued)

- Escrow for known liabilities
 - Effective where a liability is known, but cost is not, or is disputed
 - A pain to administer
 - Time limit? Who controls? Dispute resolution?
 - Hold-back in purchase price is similar

Common Risk Allocation Techniques (continued)

- Indemnities
 - Capped at a fixed amount? Is there a basket? Time limit for claims?
 - Consider credit-worthiness of indemnitor
 - Coverage – all “preclosing” conditions, or only specific ones?
 - Expect disputes if a major claim is made

Common Risk Allocation Techniques (continued)

- Releases
- Carve out properties or liabilities where parties cannot agree on risk
- Cost sharing on specified future liabilities
- Insurance Policies/Third Party Contracts
 - Many types of coverage available at surprisingly reasonable costs
 - But insurers won't take unreasonable risks
- Caution: contracts will not override statute

Environmental Insurance

- Cheaper and better than you might imagine, but market is volatile
- Protection against unknown liabilities (when they are truly unknown)
- Protection against cost overruns (when you can get it)
- Comment: Understand what you are buying before you buy it
- It is possible to negotiate terms – and wise to do so

Brownfields Relief

- In MA and many other states, efforts have been made to encourage transactions with contaminated property
 - Protects “innocent” owners, operators, tenants, lenders, down-gradient property owners from statutory liability
 - Financial assistance in form of loans, tax credits, subsidized insurance, and (rarely) grants
 - Covenants not to sue for unique circumstances
 - Of course, properties must generally be cleaned-up
 - Even if Buyer is not “liable” for contamination, dirty property may still be difficult to develop, lease, or resell

Federal Relief

- Federal brownfields legislation passed in 2002
- Some additional protections
- Not often directly affect transaction, but
- “All Appropriate Inquiry” will largely set baseline for real estate due diligence, even where federal protections aren’t key to a deal –Compliance with 1527E-2005 will become the norm

Questions?

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