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## Environmental Due Diligence and Risk Allocation in M&A Transactions

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### I. Environmental Due Diligence in M&A Transactions

Environmental due diligence in corporate transactions involves the assessment of known, potential, and contingent environmental liabilities and obligations associated with the properties and operations of the target company and its affiliates. The nature and extent of environmental due diligence is colored by the nature of the transaction and the nature of the laws and regulations to which the acquisition target is subject. Environmental due diligence can include an examination of: 1) the target company's compliance with environmental requirements; 2) the potential for liability at sites currently or formerly used by the business; or 3) sites to which the business arranged for the disposal of hazardous materials.

The information obtained from a due diligence assessment may be used for different purposes by the various parties to the transaction:

- **Buy-side Identification of Environmental Risks/Liabilities.** An environmental due diligence investigation may serve to alert a potential buyer to present or future environmental problems that may require management, remedial action, or large capital expenditures. The results may reveal potential problems that will make a target company or a particular property unattractive to the buyer and suggest abandoning the bid. Alternatively, it may allow the buyer to negotiate adjustments to the price, change the structure of the deal, or redraft other important contractual provisions.
- **Sell-side Evaluation of Potential Bids, Indemnities or Risk Transfer Products.** Due diligence is not limited to prospective purchasers. Parties looking to put a property or a business up for sale also may conduct due diligence in advance of taking the deal to the marketplace in order to better evaluate the relative value of potential bids, make informed decisions regarding indemnities, or evaluate possible risk transfer products, such as insurance.
- **Lender/Underwriter Assessment of Risks.** Parties involved in financing transactions, such as lenders and underwriters, also participate in diligence exercises, although they may substantially rely on the diligence done by the buyer/borrower or offeror. Due diligence permits a lender to assess whether contingent environmental liabilities may impair a borrower's ability to repay the loan or damage the borrower's credit rating, making it difficult or impossible for the lender to sell or securitize the loan. It also enables the lender to identify any environmental contamination that could take priority over the lender's lien, affect the desirability of foreclosing on property, or create potential environmental liabilities or adverse publicity for the lender.
- **Parties' Allocation of Environmental Liabilities.** Finally, the information obtained from environmental due diligence enables the parties to make educated business decisions regarding the allocation of environmental liabilities and influences how contractual provisions are drafted to address known and potential environmental liabilities. For example, a buyer that has conducted extensive environmental due diligence may be willing to accept fewer contractual protections for environmental liabilities because the buyer has obtained comfort through the diligence process that no significant liabilities exist.

The first section of this practice note generally discusses the types of environmental risks that can arise, how those risks can be assessed in a transactional context, and certain liability defenses that may be available and obtained through the due diligence process, in the following sections:

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- [Conducting "All Appropriate Inquiry" and Qualifying for the "Bona Fide Purchaser Defense"](#)
- [Tailoring the Scope of Due Diligence](#)
- [Development Deals](#)
- [Building Materials and Indoor Air Quality](#)
- [Emerging Issues in Environmental Due Diligence](#)

While the scope of a transactional environmental due diligence assessment will depend on many factors, including in large part the nature of the operations of the entity or assets to be acquired, the key is to structure the diligence in a manner that is most likely to identify the liabilities and risks associated with the target. Different businesses present different risks, and depending on the time and resources available to conduct due diligence, environmental due diligence should be tailored to assess the most likely risks associated with the target.

For a discussion of how to deal with environmental risks when drafting the acquisition agreement, see [Allocating Environmental Risks in the Transaction Agreement](#). For a discussion of environmental concerns during and after closing, see [Closing and Post-Closing Environmental Law Considerations](#).

## A. Conducting "All Appropriate Inquiry" and Qualifying for the "Bona Fide Purchaser Defense"

One of the best known, yet poorly understood, aspects of environmental due diligence is the concept of "all appropriate inquiry" and the "bona fide purchaser defense." The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), and similar state laws, generally provide that an owner or operator of real property can be held liable for any onsite contamination, regardless of fault; however, CERCLA offers certain statutory defenses to so-called "bona fide prospective purchasers," among others, provided that the purchaser can prove it conducted "all appropriate inquiry," a showing that it made reasonable inquiries to determine whether the property was contaminated prior to the acquisition. In other words, a party that qualifies as a "bona fide prospective purchaser" may be able to avoid CERCLA liability for any preexisting contamination subsequently found on land acquired by the purchaser.

It is important to note that a "bona fide prospective purchaser" defense is not available when the purchaser acquires the stock of an entity that holds contaminated land. This is because the entity that holds the land (if not itself a "bona fide prospective purchaser") is statutorily liable for any onsite contamination, and that liability cannot be erased by a subsequent "bona fide prospective purchaser." Thus, the "bona fide prospective purchaser" defense is only available when the purchaser is acquiring assets.

### 1. *Qualifying as a "Bona Fide Prospective Purchaser"*

To qualify as a "bona fide prospective purchaser," the purchaser must, among other requirements:

- make all appropriate inquiries into the previous uses and ownership of the facility;
- take reasonable steps to stop any continuing release;
- limit exposure to a previously released hazardous substance(s) discovered on the property; and
- not be affiliated with any person who is potentially liable for the contamination at the facility through any familial, contractual, or corporate relationship. See 42 U.S.C. § 9601(35)(A).

In 2002, Congress passed the Small Business Liability Relief and Brownfields Revitalization Act ("Brownfields Act") (Pub. L. No. 107-118, 115 Stat. 2356 (codified at 42 U.S.C. §§ 9601-9675), which mandated the development of due diligence standards to satisfy the "appropriate inquiry" requirement for parties seeking to qualify for the "bona fide prospective purchaser" exemption under CERCLA. After a lengthy negotiated rulemaking process, in November 2005 the U.S. Environmental Protection Agency ("EPA") promulgated a new "all appropriate inquiry" rule, which is currently used as a baseline for determining the level of inquiry into environmental matters for environmental due diligence in most real estate and many corporate transactions. See 40 C.F.R. pt. 312.

## 2. *Satisfying the AAI Standard*

In order to satisfy the "all appropriate inquiry" ("AAI") standard, specific tasks or inquiries must be undertaken prior to acquisition of the property. The inquiry focuses on contamination risks, setting out specified objectives for obtaining information about current and past property uses and uses of hazardous substances, waste management and disposal practices, current and past corrective actions, engineering and institutional controls at the property and environmental conditions at neighboring properties which could be indicative of releases. Many of the designated tasks must be performed by, or under the directions of, an "environmental professional." To qualify as an "environmental professional," an individual must meet certain educational, and experience requirements. See 40 C.F.R. § 312.21. Inquiries that must be conducted by an environmental professional or at their direction include the following:

- Interviewing past and present owners, operators, and occupants of the property about the handling of hazardous substances. The AAI standard requires at least one knowledgeable person from each period in the property's history be interviewed.
- Reviewing historical records, such as aerial photographs, fire insurance maps, chain of title documents, and land use records, dating back to the time when the property first contained structures or was put in use.
- Reviewing government records concerning releases and threatened releases of environmental activities on the site, including landfill and disposal unit records and permits, storage tank records and permits, hazardous waste generator records and permits, government listing of sites and spill reports. Other records to be reviewed include: EPA's Comprehensive Environmental Response, Compensation, and Liability Information System ("CERCLIS") database, public health records, Emergency Response Notification Records, and registries of engineering and industrial controls. In addition, the environmental professional must review records concerning adjoining or neighboring properties, including records of National Priority List and the Resource Conservation and Recovery Act ("RCRA") corrective action sites within one mile, and records of other sites under investigation, subject to voluntary cleanup or having a leaking underground storage tank within a half mile. The environmental professional must visually inspect the property and its improvements (including areas in which hazardous substances may be stored or handled), and adjoining properties (either from the property line or through aerial photography). Moreover, he must take into account commonly known or reasonably ascertainable information about the property as well as the degree of obviousness or likely presence of contamination at the property.
- Searching for records of environmental cleanup liens. Either the environmental professional or others working on behalf of the purchaser must search for records of environmental cleanup liens.

The "all appropriate inquiry rule" also requires that the purchaser itself perform certain tasks and inquiries, including the following:

- Disclosing to the environmental professional any specialized knowledge that the purchaser may have about the property, its uses, or surroundings.
- Considering the relationship between the purchase price of the property and the value of the property if not contaminated to determine whether any difference is attributable to releases of hazardous substances, pollutants, contaminants, or petroleum. The Preamble in the Federal Register makes clear that compliance with this requirement does not require the performance of an appraisal. Rather, the purchaser is to consider whether any reduction in purchase price is indicative of the presence of contamination.
- Disclosing commonly known or reasonably ascertainable information about the property. Even though this requirement is also part of the mandated environmental professional's inquiry, the purchaser has an independent obligation to consider this factor.

Once an "all appropriate inquiry" has been conducted, parties who satisfy the other requirements of the "bona fide prospective purchaser" exemption under CERCLA will not be liable for contamination at the site providing the party does not impede the performance of a response action or natural resource restoration. See 42 U.S.C. § 9607(r)(1).

The most standardized part of the due diligence process, and the most common way that buyers seek to perform AAI, is the American Society for Testing and Materials' ("ASTM") Phase I Environmental Site Assessment ("ESA"). The ASTM Phase I ESA is used as a baseline for determining the level of inquiry into environmental matters for environmental due diligence in

most real estate and many corporate transactions. The focus of the ASTM Phase I is on the potential for contamination at the site being evaluated. The ASTM Phase I ESA received the endorsement of the federal government in response to the Brownfields Act, and generally covers most of the elements for performing AAI described above.

### **3. Limitations of the AAI Standard**

As noted above, buyers seeking to establish one of the CERCLA defenses likely will follow the EPA rule, especially in single-property transactions. Compliance with the EPA rule, however, will not protect buyers from cleanup obligations imposed under state law or from tort liability, although compliance may provide evidence to rebut allegations of negligence or other improper conduct. Moreover, the rule may be cumbersome to follow in large corporate transactions, which involve multiple assets, and has no application in stock transactions where the real estate does not change ownership and therefore is not susceptible to the use of AAI. In addition, transactions with truncated diligence in post-signing to closing time periods often render it difficult to fulfill all requirements of the rule, and the rule seldom is followed completely in the context of larger mergers, where the buyer is assuming any on-site liabilities either as a matter of law or by contract. Nevertheless, some financial institutions, generally in the context of financing single properties, may require complete compliance with the rule as a condition of lending.

Many lawyers, consultants, buyers and lenders tend to focus on the alleged protections to be gained by following the EPA's all appropriate inquiry standard, which in essence codifies the ASTM standard. Doing so, however, leaves significant risks unaddressed. First, the AAI protections apply solely to liability under CERCLA with no affirmative effect on state statutory or common law claims, such as trespass or nuisance. Second, the AAI standard has no bearing on the allocation of liability in the context of a stock transaction or if the purchaser agrees to assume onsite conditions in the purchase agreement. Moreover, the AAI standard and the ASTM counterpart focus purely on contamination risks at a specific property, but there are a host of other issues that need to be evaluated in the context of a transaction in order to understand the risks associated with a particular investment, including compliance, pending changes in law, energy efficiency, climate change, and water risk.

## **B. Tailoring the Scope of Due Diligence**

As noted above, the nature of a deal will affect the scope of diligence done. The scope of an environmental due diligence exercise concerning a chemical business, for example, should be much more thorough than that which might be conducted on a software developer. A development deal, on the other hand, may warrant a review for endangered species and wetlands, both of which, if present, could adversely affect development plans or, if discovered during development, could result in fines and penalties or delays during construction, or warrant changes in development plans, all of which cost the developer expenditures beyond the initial budget. Transaction structure will also play an important role. A stock deal warrants attention not merely to current assets, but also to any sites formerly used by the target or to which the target sent hazardous materials for disposal or treatment. Moreover, general principles of corporate law prescribe that liabilities, such as environmental liabilities due to pre-closing non-compliance with environmental laws, continue to exist as liabilities of the acquired entity in a stock acquisition or as liabilities of the surviving corporation in a merger.

An in-depth discussion of potentially relevant considerations continues below:

### **1. On-Site Contamination**

Parties acquiring real property in a transaction must exercise substantial scrutiny as federal environmental laws such as CERCLA and RCRA, as well as analogous state statutes, impose broad, joint and several liability on owners and operators of real property for onsite contamination without regard to fault. This means that liability can be triggered without any action on the part of the owner or operator of the site, though lessees of real property may have a cause of action against their landlord or a third party for contamination that predates their occupation of the property. Statutorily liable parties may not be able to rely on traditionally available contract, tort, or equitable defenses such as causation by third parties, proximate cause, or adherence to prevailing standards.

Owners or operators of potentially contaminated property can face additional concerns beyond potential costs associated with investigation or remediation. A number of state statutes such as New Jersey's Industrial Site Recovery Act (N.J. Stat. Ann. §13:1K-6 et seq.) and Connecticut's Transfer Act (Conn. Gen. Stat. Ann. § 22a-134), require disclosure of environmental conditions and remediation or other consent before industrial businesses or the underlying real estate may be transferred. Moreover, owners of contaminated property can be vulnerable to common law claims grounded in causes of action such as negligence as well as toxic tort litigation aimed at compensating plaintiffs who claim injury due to exposure to hazardous materials. Accordingly, any party acquiring real estate in connection with a transaction should apprise itself of the actual and potential liabilities that it may assume upon acquisition due to the presence or release of hazardous materials.

## **2. Compliance with Current and Pending Laws**

Because a Phase I ESA is looking predominantly for conditions that could give rise to contamination, a thorough environmental due diligence investigation also should include an examination of the target entity's compliance with environmental laws and environmental permitting requirements. This is particularly true in industries that are subject to extensive and highly-technical environmental requirements, such as power generation or chemical manufacturing, as violations of environmental laws can result in substantial fines and penalties, lack of authority to operate, significant capital expenditures to obtain or maintain compliance, and increasingly negative publicity. For stock deals, it is important that the buyer consider the entity's historic compliance, at least dating back to a period of time equal to the applicable statutes of limitations, which typically run three to five years, as the liabilities of the target entity will attach to the buyer or the surviving corporate entity in a merger once the transaction is consummated. Moreover, buyers need to evaluate pending changes in environmental requirements that apply to the target's operations because these changes can result in material capital expenditures to maintain compliance.

Since compliance evaluations are beyond the scope of a typical ASTM Phase I, a buyer conducting diligence on environmentally sensitive businesses should consider requiring its consultant to conduct some form of a compliance review or audit as part of its evaluation. Topics generally covered by a limited compliance review include:

- an assessment of a target's or site's environmental management system;
- permitting status;
- emissions to air including control measures;
- water and wastewater supply;
- use and management;
- hazardous materials and waste management; and
- noise concerns.

## **3. Former Sites**

Under CERCLA and analogous state laws, a former owner or operator of a site may be held liable for contamination at its former sites if the disposal or release giving rise to the contamination occurred during the period in which that entity owned or operated the site. As such, to the extent possible, acquirers of stock should evaluate the existence of, as well as the nature of operations at, the target's former sites. Information pertaining to former sites can be difficult to obtain, and is often dated. For this reason, and because site access often cannot be obtained, it is advisable to conduct searches of publicly available information or order proprietary database reports on potentially problematic sites.

## **4. Contractual Indemnities**

Contractual indemnities provided by the target to third parties covering divested or formerly operated properties also can be a source of potential liability for a buyer; as once the acquisition closes, the buyer will take on the target's contractual obligations. As such, it is critical to evaluate the terms of any purchase or divestiture agreements to which the target is a

party, to understand whether such indemnities exist as well as whether there are limits to the potential exposure. Prospective buyers can also benefit from environmental indemnities that benefit the target; however, it is critical to understand that such indemnities do not eliminate the prospect of liability if statutory liability has attached to the target. Contractual indemnity provisions merely shift liability from one party to another. If the indemnitor is unable or otherwise refuses to honor its indemnity obligation to the indemnitee, the indemnitee can still be held liable under applicable law for contamination caused during its period of ownership or operation.

## **5. Off-Site Disposal of Hazardous Substances**

Under many environmental laws, including CERCLA, a party that arranges for the disposal or treatment of hazardous substances (a "generator") is potentially liable, with other generators, for the cost of investigating and remediating contamination found at the disposal site if it becomes contaminated. See 42 U.S.C. § 9607(a)(2). Typically, generator liability arises when an industrial business contracts with a disposal service for the removal of hazardous waste from the company's plant. The contractor transports the waste to a disposal site that is eventually subject to a CERCLA cleanup. As with on-site contamination, such liability is often imposed on a joint and several basis without regard to fault. It makes no difference that the generator had no part in the actual placement of hazardous waste at the disposal site or in choosing the site to which the waste was shipped. As such, prospective buyers conducting due diligence on targets where off-site disposal liability is potentially a concern should consider reviewing the EPA and state websites that maintain public records online regarding enforcement of environmental laws and cleanups, as well as target documents and records concerning the storage, transportation, treatment or disposal of hazardous waste, including hazardous waste manifests.

## **C. Development Deals**

In addition to concerns regarding contamination, prospective purchasers need to pay attention to on-site conditions that could increase the cost of development, such as migrating contamination from third-party sites for which the owner would have no statutory liability, wetlands, or habitats for endangered or threatened species.

### **1. Migrating Contamination**

In most jurisdictions, an innocent owner is not responsible for contamination that originates offsite and migrates onto the innocent owner's site unless operations at that site also contributed to the contaminant plume. In fact, some states, such as Massachusetts and Texas, have programs that provide such parties with certificates declaring the absence of liability. See 1998 Mass. Acts 206; 310 Mass. Code Regs. 1.00 et seq.; Tex. Health & Safety Code Ann. § 361.601 et seq. Just because there is no obligation to remediate, does not mean that the contamination can be ignored. The presence of contamination requires special protections for employees who come into contact with it during construction. Moreover, even if a landowner is exempt from cleanup liability, migrating contamination could create a risk to your tenants or occupants that is substantial enough for a regulatory authority to require assessment and mitigation of vapor intrusion concerns. These mitigation measures typically include sub-slab vapor barriers and passive ventilation systems, which are similar to the measures employed to address radon concerns.

### **2. Wetlands**

Developers of real property need to be aware that stringent laws are in effect regulating development of wetlands. Wetlands subject to federal control are often referred to as "jurisdictional wetlands" because they are subject to the regulatory jurisdiction of federal law. Jurisdictional wetlands are regulated under Section 404 of the Clean Water Act of 1972 because they are important for the protection of aquatic species and waterfowl, water purification, and flood control. See 33 U.S.C. §§ 1251-1387. The EPA and the U.S. Army, Corps of Engineers, the two federal agencies with the authority to regulate wetlands, identify wetlands as "those areas that are inundated or saturated by surface or groundwater at a frequency and duration sufficient to support, and that under normal circumstances do support, a prevalence of vegetation typically adapted for life in saturated soil conditions." See [Envtl. Technical Servs. Co., Federal Manual for Identifying and Delineating Jurisdictional Wetlands \(Jan. 10, 1989\)](#).

Prior to purchasing a property for development, the prospective buyer should conduct a wetlands survey for several reasons. First and foremost, a determination that jurisdictional wetlands are located on the undeveloped property that is the subject of the transaction may profoundly affect the value of the property. Such a finding can result in significant delays and extra costs to the developer because the permitting process can be complicated and open to interpretation regarding the potential impact of the development activities and the potential mitigation measures that are necessary. Moreover, heightened public scrutiny with respect to the protection of wetlands increases the possibility that various interests could use the wetlands regulatory scheme to block or delay development approved by zoning plans. Next, developers should determine whether wetlands are present because the destruction of wetlands can result in substantial administrative, civil, and criminal penalties under Section 404 of the Clean Water Act. See 33 U.S.C. §§ 1311(a), 1344. Because the Clean Water Act is a strict liability statute, no intent to destroy wetlands needs to be proven to establish a civil violation.

## **D. Building Materials and Indoor Air Quality**

Most environmental laws and regulations focus on limiting the release of chemicals to the outdoor environment even though many of us tend to spend more time indoors than out. Potential asbestos and lead-based paint hazards in building materials have long been recognized as concerns in buildings and, while no comprehensive regulatory program at either the state or federal level sets general standards for indoor air quality, purchasers of real property need to be aware of potential indoor air hazards from radon, mold and vapor intrusion (discussed at [Emerging Issues in Environmental Due Diligence – Vapor Intrusion](#)).

### **1. Asbestos**

The presence of asbestos in commercial buildings may generate both legal and business concerns for purchasers, developers, and other investors in commercial real estate. Building owners also can potentially face tort liability for personal injuries caused by exposure to asbestos. Moreover, failure to comply with regulations designed to protect employees in the workplace from exposure to airborne asbestos fibers and to prevent the release of asbestos fibers into the environment during renovation or demolition can result in substantial fines or penalties. See 29 C.F.R. § 1910.1001. The Occupational Health and Safety Administration's ("OSHA's") asbestos regulations consist of three standards; however, the general industry standard will normally apply to commercial real estate. OSHA's regulations also require building owners to inform employees about the presence and location of asbestos containing material ("ACM"). The Asbestos National Emission Standards for Hazardous Air Pollutants ("Asbestos NESHAP") establishes emission restrictions and work practices for a variety of asbestos-related activities. The Asbestos NESHAP is currently found in 40 C.F.R. § 61.140 et seq. The type and amount of asbestos that will be disturbed during the project determines whether the Asbestos NESHAP applies. See 40 C.F.R. § 61.145(a).

The mere presence of asbestos in a building is typically not a transaction deal breaker as long as it can be managed in place through an Operations and Maintenance ("O&M") Program. U.S. EPA's book, [Managing Asbestos in Place](#), commonly called "The Green Book," is the primary source of EPA guidance on the topic of managing asbestos in buildings. O&M Programs typically include provisions specifying work processes to:

- maintain ACM in good condition and prevent disturbances;
- ensure the proper cleanup of asbestos fibers that have been released;
- prevent the further release of asbestos fibers; and
- monitor the condition of the ACM present at the property.

That said, obtaining a thorough understanding of the location and condition of any ACM can be critical for a buyer. In addition, since an asbestos evaluation generally falls outside the scope of a Phase I ESA, prospective purchasers should specifically request an asbestos inspection where the presence or condition of ACM is thought to be a concern. First, the buyer will want to ensure that substantial quantities of friable ACM do not exist in areas that are accessible or otherwise subject to dispersal to the building's occupants or the public. Next, identifying the location of asbestos can be a critical factor in assessing costs for renovation due to the federal and state requirements that must be met when asbestos is abated as these mandated special work practices, which can only be carried out by specially licensed contractors, can

materially increase construction costs. See 40 C.F.R. § 61.145(c). These prescribed work practices generally are highly technical; however, they have a single purpose – to keep asbestos fiber release to a minimum. Costs of managing the asbestos in place should also be considered in relation to the property's value.

## **2. Radon**

Radon is a colorless, odorless gas that comes from the natural radioactive breakdown of uranium in the ground. Radon can infiltrate indoor air through the soil under the building or the water used in the building. According to the EPA, inhalation of radon can increase an individual's risk for developing lung cancer. See U.S. EPA, [Radon Health Risks](#). In order to identify potential radon risks, the prospective purchaser should test the air at the likely entry point, typically the building's lowest level. High radon readings can typically be addressed through mitigation measures that usually include vent pipes and fans to prevent radon from seeping into the building. Costs for implementing these types of mitigation measures generally are not considered expensive in the context of most transactions.

## **3. Lead-Based Paint**

Lead-based paint generally is recognized as a significant health risk to young children and pregnant women as ingestion can cause permanent damage to the brain and nervous system leading to behavior and learning problems, lower IQ, and hearing problems in children and an increased risk of miscarriage and birth defects for pregnant women. Although the use of lead-based paint has been banned in the U.S. since 1978, many residential and commercial structures, particularly those built before 1950, potentially contain lead-based paint. The EPA regulations require notice of potential lead-based hazards during the sale or lease of certain housing (see 24 C.F.R. Pt. 35) and specify that lead-based paint inspections and abatement can be performed legally only by certified parties. See 40 C.F.R. Pt. 745. Prospective purchasers need to be aware that a failure to identify or properly abate lead-based paint hazards ultimately can result in personal injury claims alleging lead poisoning that are based on theories of negligence, strict liability, or breach of express or implied warranty. Buyers of buildings that potentially contain lead-based paint should consider whether it or the seller should bear the cost of an inspection, risk assessment or the cost of abatement if lead-based paint is identified.

## **4. Mold/Water Intrusion**

Mold is a substance that is naturally occurring, so it is always present in the environment. Outdoors, molds are an integral part of natural processes, breaking down leaves, wood and plant debris; however, indoors, mold spores grow by digesting whatever organic substance they land on, including wallpaper, insulation, drywall, and roofs. According to the EPA, exposure to mold can potentially be a health risk ranging from mild and temporary allergic reactions to more severe illnesses such as lung infections. See U.S. EPA, [Mold Resources](#). As such, damages from a toxic mold claim could include repair costs, damages for loss of use of property or items, relocation expenses, depreciation of property value damages, and personal injury related costs.

Mold investigations are typically beyond the scope of a traditional ASTM Phase I; however, an environmental evaluation of property should include a non-invasive assessment to identify visual evidence of mold, such as discoloration on surfaces, evidence of water intrusion or leakage or flooding problems, suspect growth within the HVAC system and any suspect odors. A prospective purchaser also should pose questions to the seller regarding the history of complaints from building occupants regarding mold and air circulation. If a history of building occupant complaints is identified or if an initial inspection detects suspect conditions, it may be necessary to conduct follow up sampling of the air and building materials. If possible, the prospective purchaser also may seek to collect and test samples from building surfaces to determine whether mold growth is present.

## **E. Emerging Issues in Environmental Due Diligence**

Businesses and investors must constantly adapt to an emerging set of environmental issues driven by global events and conditions, legislation, and increasingly, investor concerns about environmental and social issues. Parties tasked with conducting environmental due diligence must keep informed of these new issues in order to effectively incorporate them into their due diligence review. Environmental issues that have gained a significant amount of traction in recent years

include: regulatory and physical risks related to climate change, water-related risks, environmental, social and governance ("ESG") issues, and vapor intrusion. In particular, investor focus on evaluating the ESG performance of a business is becoming more commonplace as a means of driving more profitable operations and creating long-term value, especially amongst institutional investors and private equity funds with European ties.

## 1. *Climate Related Risks*

Investors and businesses continue to sharpen their focus on climate change-related risks, primarily due to the potentially significant financial impacts of climate change on individual businesses as well as the global economy. Climate change risks generally can be broken down into two categories: physical risks or regulatory risks. There may also be certain compliance assets that buyer should understand. Each of these factors is discussed below:

- **Physical Risks.** Physical risks include risks to land, infrastructure, or other corporate assets due to the wide-ranging impacts that may be attributed to climate change, including changes in seasonal patterns, rising sea levels, increased severity and frequency of extreme weather events, such as tropical storms and cyclones and increased severity of drought. Physical risks can be difficult to assess since they may arise well into the future or otherwise be contingent or speculative.
- **Regulatory Risks.** Regulatory risks are more straightforward from a diligence perspective and stem from governmental efforts to address climate change and influence corporate strategy. These types of risks disproportionately impact carbon intensive businesses, such as electricity generators or chemical producers, because new laws or regulations are generally aimed at capping or otherwise limiting greenhouse gas emissions. Here in the U.S., the Supreme Court ruled in *Massachusetts v. EPA*, 549 U.S. 497 (2007), that the EPA has the authority under the Clean Air Act to regulate carbon, which resulted in several regulatory initiatives aimed at curtailing greenhouse gas emissions. Several of these initiatives present significant challenges for the power sector, in particular, the coal industry. For example, the EPA's carbon emissions standards for new and existing power plants have the potential to dramatically shift power generation away from coal and oil-fired power plants and towards natural gas and renewable power sources. Businesses exposed to these types of regulatory risks could face material increases in costs associated with compliance, including those associated with decreasing corporate reliance fossil fuels, converting to low-carbon technologies, and/or improving energy efficiency, or incur significant fines or penalties for failing to comply.
- **Compliance Assets.** In addition to compliance risks, there may be compliance assets associated with climate change of which a prospective buyer needs to be aware. Under certain statutes, businesses that take certain steps to reduce greenhouse gas emissions, or make use of renewable energy generating technologies, may be entitled to certain "credits" that can be used by the business to meet compliance obligations or sold to other entities to meet their compliance obligations. If such credits are available, it will be important during the diligence process to understand whether such credits are needed to meet the target's compliance obligations, and if so, whether sufficient credits exist to meet those obligations or whether additional credits must be obtained, and at what cost.

A due diligence review aimed at assessing the level of commercial and legal risks related to complying with the EPA's regulations regarding climate change, and any compliance assets that may be available, is clearly warranted for targets that are significant greenhouse gas emitters, particularly those involved in power generation, an industry subject to the most significant climate change-related regulation.

## 2. *Water Risks*

Businesses rely on a clean and reliable supply of water for industrial purposes, support functions, facility operations, and as an ingredient for many products. Traditionally, these same businesses took an abundant and affordable supply of clean water for granted; however, today, as population growth, industrialization, urbanization, and the impact of climate change place unprecedented stress on the global water supply, corporate attitudes towards water are changing. Businesses and investors alike are currently beginning to recognize the true value of water as well as the diverse ways in which water issues can create risks to businesses, particularly in certain regions and business sectors.

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Water intensive business sectors include: beverage production, chemical production, oil and gas exploration, electric power production, semiconductor production, and mining. In particular, the use of freshwater associated with hydraulic fracturing, or fracking, in connection with oil and gas production is one area under increased scrutiny due to the substantial quantities of water used to frack each well. For example, Texas lawmakers, motivated by a severe drought that has impacted much of Texas, have recently responded by proposing a variety of regulations aimed at imposing more stringent regulation on the use of freshwater in drilling and fracking.

Businesses can be subject to water risk in a variety of ways:

- **Operational Risk.** First, water risks can arise as direct and specific risks to business operations, such as business interruptions due to water shortages, water quality or treatment issues, supply chain interruptions, or increasing water supply costs.
- **Reputational Risk.** Businesses also may face heightened public scrutiny regarding the volumes of water they are extracting or the pollutants they are discharging to the increasingly coveted resource.
- **Regulatory Risk.** Businesses may become increasingly subject to more stringent regulatory oversight regarding water use, including burdensome restrictions on water allotments or use.
- **Capital Risk.** Increasingly, water uncertainty could lead to restricted access to capital as lending restrictions or more stringent investment policies are crafted to address water risk.

As such, a business' susceptibility to water-related risks is beginning to warrant additional scrutiny during the due diligence process.

In order to diligence a company's potential exposure to water risk, several considerations must be evaluated:

- **Understand the company's direct and indirect water use in order to assess water risk associated with the company's operations and supply chain.** Assess by: (1) confirming the company's legal rights and obligations with respect to quantity, quality, price, reliability, and duration of water supply and the viability of these resources; and (2) determining whether operations are located in a water-stressed region or a region that could foreseeably face water stress in the future. If operations are located in a water-stressed region, is that demand likely to grow?
- **Understand whether there are water risks related to the target's supply chain.** For example, are the company's products and services dependent upon the quantity, quality, price, reliability, or duration of its various suppliers' own water supplies? Finally, a prospective buyer should determine whether the company has integrated water risk into its risk management and governance structure.

### 3. *Environmental, Social and Governance Issues*

Environmental, social, and corporate governance, also known as ESG, refers to the three main areas of emphasis that have developed as central factors in measuring the sustainability and ethical impact of an investment in a company or business:

- **Environmental.** The environmental component of ESG ranges from traditional risks related to contamination, compliance with environmental laws, and hazardous waste generation to emerging areas of focus, such as energy efficiency and sustainability. Sustainability, which refers to the capacity of a business or product to endure, in particular, has become one of the more crucial elements for investors in making ESG-based decisions. When attempting to ascribe long-term value to a particular venture or industry, an assessment of that venture's sustainability should measure a broad range of factors, such as the potential future obsolescence of a business' product or service, the depletion of resources associated with company operations, and the dependency of production on a diminishing availability of raw materials.
- **Social.** The social prong of ESG refers to a broad range of social matters that are increasingly impacting corporate operations and access to capital as investors seek to encourage corporate practices that promote human rights, diversity, consumer protection, and employee relations.
- **Corporate Governance.** Finally, an assessment of corporate governance principles requires an investigation into the rights and responsibilities of the management of a company. Topics such as bribery, corruption, and executive compensation are usually the focus of any evaluation of corporate governance issues. As with traditional environmental diligence, ESG-related diligence should be scoped to address the specifics of a particular target or

transaction. An energy or water intensive business with extensive operations in the developing world is likely to present more ESG-related risks and impediments to consummating a deal than a domestic software business. Because not all ESG-related issues fall within the environmental realm, it is important to ensure that risks falling under the social and governance prongs are assessed by someone on the transaction team.

Institutional investors, including many private equity funds, are increasingly incorporating ESG considerations into their operations as well as including an analysis of ESG risks and opportunities in their respective due diligence processes in order to better manage risk and create value. For example, the United Nations-supported Principles for Responsible Investment ("UNPRI") Initiative has seen a remarkable increase in the number of signatory parties over the past five years, now representing approximately 1200 asset owners, investment managers and professional service partners with nearly \$35 trillion in assets under management. See UNPRI, [About the PRI Initiative](#). UNPRI's goal is to "understand the implications of sustainability for investors and support signatories to incorporate these issues into their investment decision making and ownership practices."

Signatory parties to UNPRI commit to six principles based on their fiduciary duty to act in the best long-term interests of their beneficiaries and desire to contribute to the development of a more sustainable global financial system. Signatory parties agree to the following six principles:

1. incorporating ESG issues into investment analysis and decision-making processes;
2. being active owners and incorporating ESG issues into ownership policies and practices;
3. seeking appropriate disclosure on ESG issues by the entities in which signatory parties invest;
4. promoting acceptance and implementation of the UNPRI principles within the investment industry;
5. working together to enhance signatory party effectiveness in implementing the Principles; and
6. reporting on activities and progress towards implementing the Principles.

See UNPRI, [The Six Principles](#). Members of the Private Equity Growth Capital Council, a trade association established to develop, analyze, and distribute information about the private equity and growth capital investment industry, follow a similar set of guidelines. See Private Equity Growth Capital Council, [Guidelines for Responsible Investing](#).

Although standard ESG metrics have yet to be developed or embraced by the investment community, such metrics and performance indicators are likely to materialize, especially if this long-term view remains prevalent amongst investors.

#### **4. Vapor Intrusion**

Another issue drawing increased scrutiny from regulators and lenders on commercial real estate transactions is the risk of vapor intrusion. Vapor intrusion can occur when there is contaminated soil or groundwater located beneath an overlying building. Certain contaminants emit vapors that may rise through soils and into indoor air spaces, where they can pose both short and long-term safety risks. In the short-term, a buildup of vapor in an enclosed structure can create risk of explosion, hazardous exposure levels, or aesthetic problems (e.g., odors). Typically, however, the chemical concentration levels are low. In these cases, there is a concern that vapor intrusion may pose an unacceptable risk of chronic health effects due to long-term exposure to these low contaminant levels. Regulatory agencies are increasingly reevaluating certain sites that received regulatory closure, but still have residual contamination, to determine whether vapor intrusion pathways were examined during the original investigation and remediation phase.

Evaluating the potential risk from vapor intrusion can be difficult, especially when trying to determine whether the same chemicals from emission sources in the building (e.g., household solvents, gasoline, cleaners) may pose, separately or in combination with vapor intrusion, a significant human health risk. In June 2015, the EPA issued vapor intrusion guidance that seeks to provide EPA and property owners with a framework for assessing and addressing vapor intrusion risk. See EPA's Office of Solid Waste and Emergency Response, [Technical Guide For Assessing and Mitigating the Vapor Intrusion Pathway From Subsurface Sources to Indoor Air \(June 2015\)](#). The EPA's vapor intrusion guidance provides step-by-step

recommendations for identifying, assessing and mitigating short and long-term risk associated with vapor intrusion in both commercial and residential buildings. Generally, the guidance recommends that a detailed vapor intrusion investigation, including both indoor and subsurface sampling, take place when available information suggests that volatile chemicals may be present in soil and groundwater beneath an existing or proposed structure.

For prospective buyers of property with known or suspected contamination beneath existing or proposed structures, it will be important to understand the EPA's vapor intrusion guidance to determine what steps, if any, might be necessary to assess vapor intrusion risk. This is because the EPA (or concerned state regulators) unilaterally may determine that a vapor intrusion risk assessment is necessary if certain conditions exist, raising the prospect of regulatory action, even at locations where contamination previously had been addressed to the satisfaction of the regulator. Moreover, to the extent that property owners become subject to litigation alleging personal injuries from vapor intrusion, the vapor intrusion guidance may serve as a benchmark against which property owners will be measured.

## II. Allocating Environmental Risks in the Transaction Agreement

Upon completion of the environmental due diligence investigation, the buyer should have obtained a solid understanding of the environmental issues requiring attention after operations are acquired. Furthermore, the new information allows the purchaser to intelligently address environmental issues in deal negotiations. The primary way in which environmental information is used in deal negotiations is to enable the parties to allocate financial responsibility between each other and to make sound business decisions in the context of the overall transaction. This allocation may occur in several ways. For example, the parties may negotiate a different purchase price or may change the structure of the transaction. Alternatively, the seller may agree to pay for some, or all, of the costs of cleanup, or choose to indemnify the purchaser against future environmental liabilities. In some cases, the purchaser may concede to all of seller's terms because the risks or liabilities, when evaluated from a worst case perspective, would not be material to the bottom line of the overall transaction.

The most important contractual provisions for understanding and allocating environmental liabilities in the agreement are the following:

- [Environmental Representations and Warranties](#)
- [Indemnification](#)
- [Access Rights](#)

Each of these types of provisions is discussed in more detail below. For a discussion of environmental due diligence, see [Environmental Due Diligence in M&A Transactions](#). For a discussion of environmental concerns during and after closing, see [Closing and Post-Closing Environmental Law Considerations](#).

### A. Environmental Representations and Warranties

Environmental representations and warranties can serve two purposes: first, they can help facilitate due diligence by requiring a seller to disclose what it knows about certain environmental matters; second, they can help to allocate liability for environmental matters between the buyer and seller. As with any transaction agreement, the representations and warranties concerning environmental matters will vary depending on the nature of the assets or business being acquired. That said, in today's environment, nearly every purchase agreement will contain at least some environmental representations and warranties. These typically require the seller to represent that, except as might otherwise be disclosed to the buyer:

- there is no contamination present at the properties being acquired;
- the operations of the acquired company have not caused any contamination at any other property;

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- the assets or business are and have been in compliance with environmental laws; and
- there are no environmental proceedings pending or threatened concerning the assets or the business.

## 1. *Tailoring Reps and Warranties*

Environmental representations and warranties should be tailored to the business or assets at issue. For example, if the target is a corporate entity that has been built through a series of acquisitions, it may make sense to include a representation that the business did not assume, by contract or otherwise, any liabilities of any third parties. If the target has a long history of manufacturing, a buyer might request a representation that the business does not and has not manufactured products containing hazardous materials such as asbestos. If a buyer feels that it has not had an opportunity to conduct ample facility-level diligence, it may request a representation that certain features are not present on any acquired real property, including underground storage tanks, landfills, or wetlands. Buyers also often seek to have a seller represent that the seller has made available to the buyer all material environmental documentation so that the buyer can obtain some level of comfort that they are aware of all known environmental liabilities.

## 2. *Qualifying Reps and Warranties*

Depending on the nature of the assets or businesses that are the subject of the transaction, it may be necessary to include certain qualifications on the environmental representations and warranties, particularly with respect to materiality and knowledge. For example, a purchase agreement for a highly-regulated chemical business would likely contain language in the representations providing that the business is and has been in "material compliance" with all environmental laws; or that the business has been in compliance except for any noncompliance "that could not reasonably be expected to result in the company incurring material liabilities." Representations also may be qualified by knowledge. For example, the seller would represent that, to its knowledge, the assets are free of any contamination. Whether and when materiality and knowledge qualifications are appropriate for environmental representations and warranties will largely depend on the nature of the transaction and the parties' tolerance for assuming or retaining risk and the strength of its bargaining position.

For a sample material adverse change ("MAC") definition, see ["Material Adverse Change" Definition](#). For a discussion of knowledge qualifiers, see [Knowledge Qualifiers in Representations](#), and for a sample knowledge definition, see ["Knowledge" Definition](#).

## B. **Indemnification**

Depending on the outcome of environmental due diligence, the nature of the deal and the bargaining strength of the parties, certain transaction agreements may provide the buyer with an indemnity in the event that the seller breaches an environmental representation or warranty.

### 1. *Survival Period*

A key consideration in such agreements is whether the environmental representations "survive." In agreements where the representations survive, the buyer may be entitled to indemnification (often subject to deductibles and caps) if it turns out that a representation was not true and the buyer incurred a loss as a result of the breach before the termination of the survival period. Survival periods for environmental representations vary, much like they do for other types of representations: they can survive for a brief period of time or, in some rare instances, they may survive forever.

One variant on the survival concept seen in some agreements provides that the representation will survive until the expiration of the statute of limitations. This presents a unique issue in the environmental context because the statute of limitations under certain environmental laws does not begin to run until the environmental issue is discovered. A survival period tied to the statute of limitations arguably creates a situation where that representation would survive indefinitely. For example, if an agreement contains a representation that there is no contamination present at real property acquired by the buyer, and that representation survives until the expiration of the statute of limitations, then arguably the buyer could demonstrate a breach of the representation if, 20 years hence, contamination attributable to the seller is discovered at the property.

## 2. Indemnification for Environmental Matters

In addition to indemnification for breaches of environmental representations, it may be appropriate for the parties to agree to a specific indemnification for environmental matters. These can take many forms and cover specific known issues, contingent liabilities, or both. Specific environmental indemnities can be particularly useful when due diligence has identified a known issue, but the magnitude of the liability cannot yet be calculated. In those circumstances, the parties may not be able to agree on a purchase price adjustment to account for the liability, and so may agree to a special environmental indemnification that will provide the buyer with some level of protection while allowing the transaction to close before the full extent of the liability is known.

Agreements containing indemnification for environmental matters may also contain certain environmental-specific limitations:

- **"No-Dig" Provisions.** For example, the agreement may provide that the buyer will not be entitled to any indemnification to which it might otherwise be entitled if the loss incurred by the buyer arises because the buyer conducted environmental sampling during the indemnification period. Often referred to as a "no-dig", these provisions prevent a buyer from voluntarily looking for issues and then seeking indemnification under the agreement. "No-dig" provisions are often subject to several exceptions, including to the extent sampling is required by law or demanded by a governmental entity.
- **No Recovery if Changes to Site.** Environmental indemnities may also be subject to restrictions that prevent recovery to the extent the buyer changes the use of a site after closing or ceases operations, both of which can change the legal requirements applicable to the site.
- **No Recovery for Cleanup beyond Required Levels.** In addition, there may be specific indemnity limitations that prevent recovery for losses incurred to cleanup a site to a level greater than required by law, i.e., if the law allows for low levels of contaminants to remain in the ground, the indemnity will not cover losses to cleanup contaminants that the law would allow to remain.

In short, environmental indemnification rights and obligations can vary significantly from transaction to transaction, and are often dictated by the issues identified (or not identified) during the due diligence process.

### C. Access Rights

While a significant portion of environmental due diligence will occur prior to signing a definitive agreement, in certain transactions environmental due diligence will continue to occur between signing and closing. To the extent that the buyer wants to continue environmental due diligence after signing the agreement, the buyer will need to ensure that it has the right to do so in the agreement. Most transaction agreements will include provisions granting a buyer certain access to the seller's properties and records. These access provisions often include limitations that prevent a buyer from conducting invasive environmental sampling. To the extent that a buyer believes it may wish to perform such sampling, it should seek to include language in the access provision explicitly authorizing it to do so. Sellers are often reluctant to provide buyers with the right to conduct invasive sampling because, if the buyer identifies a significant issue, the contract may allow the buyer to terminate the deal, leaving the seller to deal with a new environmental liability. Conversely, buyers may wish to seek to include rights to conduct sampling in the access provisions where earlier diligence suggests that there may be a potentially significant issue at a property. Depending on the deal dynamics, the seller may have no choice but to agree.

## III. Closing and Post-Closing Environmental Law Considerations

This section covers the following environmental concerns during and after closing an M&A transaction:

- [Permits and Authorizations](#)
- [Financial Assurance Obligations](#)
- [Ongoing Environmental Obligations](#)

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For a discussion of environmental due diligence, see [Environmental Due Diligence in M&A Transactions](#). For a discussion of how to deal with environmental risks when drafting the acquisition agreement, see [Allocating Environmental Risks in the Transaction Agreement](#).

## A. Permits and Authorizations

Depending on the nature of the business or assets, a seller and buyer may need to cooperate to ensure that required permits and authorizations are in place before the transaction can close. For example, in an asset sale, the parties may need to transfer certain environmental permits relating to air emissions, wastewater or stormwater discharges, or hazardous waste storage. Transferring an environmental permit can be a time-consuming undertaking, so if due diligence identifies the need to transfer permits, the parties would be wise to engage with the permitting entity shortly after signing, to facilitate a timely closing. In a stock sale, if the permitted entity is being transferred from the seller to the buyer, the permit should transfer without the need to seek a formal transfer. That being said, certain states require the parties to notify the permitting agency if there is a change in control of the permitted entity, and the permit may need to be amended to make administrative changes, e.g., the name of the plant manager or the mailing address for notices.

## B. Financial Assurance Obligations

In addition to permit transfer considerations, certain transactions may involve the transfer of financial assurance obligations. In certain circumstances, an environmental regulator may require a business to provide financial assurance, particularly if the business is conducting a significant environmental cleanup, or if the business has significant reclamation obligations (e.g., a mining company). Where a business with financial assurance obligations is being sold as part of a transaction, there may be a need to arrange for alternate financial assurance before the transaction can close. Because financial assurance obligations differ from state to state, and the methods for meeting those obligations can vary substantially, parties to a transaction involving the transfer of environmental financial assurance obligations will need to understand not only the nature of the obligation, but what options the buyer has to meet those obligations. For example, a large, publicly traded company may be able to meet its financial assurance obligation simply by demonstrating to the agency that it has sufficient assets to meet whatever environmental liabilities arise; however, the buyer may not be able to make such a demonstration and may be required to establish a trust and fully fund the obligation, which could impact the economics of the deal.

## C. Ongoing Environmental Obligations

After the due diligence is complete, the agreement is signed, and the permits and financial assurance obligations are transferred, the transaction can close. Even though the transaction may be complete, the parties' environmental obligations continue. The buyer is now responsible for maintaining compliance with environmental requirements. The seller may have continuing obligations to indemnify for, or even conduct, environmental remediation, depending on how such obligations are allocated in the sale agreement. The parties may also have specific obligations with respect to any third party claims that arise after the closing. Additionally, in most transaction agreements, there are post-closing covenants that require the parties to cooperate and share documents to respond to any government inquiries, at least for a certain period of time. While it may seem that environmental obligations are never complete (and, indeed, that may be accurate), if a buyer can perform – and the seller will facilitate – a robust environmental due diligence assessment, it increases the likelihood that both parties will remain satisfied with the deal.

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