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Management of Environmental Liabilities in Business Transactions

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This Comment seeks to prepare lawyers to address environmental risk management in the context of transactions, including: (i) transfers of ownership of corporate assets and of real property; (ii) extensions of secured credit; and (iii) issuance of securities. It offers tools for lawyers to assist clients in the identification of environmental risks, their assessment, and their avoidance or allocation to others. It also assists clients in understanding the goals of lawyers seeking to assess and manage environmental liabilities.

I. The Lawyer's Contribution

Environmental liability risks are omnipresent in transactions. However, like other risks, if they are properly managed, they need not be an obstacle to completing a transaction successfully. The principal features that distinguish environmental liability risks from other business risks are:

(i) the frequent uncertainty in their quantification that is associated with the difficulty and cost of obtaining fuller information about them;

(ii) the extended time frame over which they may unfold; and

(iii) the interdisciplinary character of the professionals required for their proper assessment and management.

These features in essence are each associated with the interactions among often complex biological and physical processes on the one hand, and on the other of legal proceedings, including legislation, rulemaking, permitting, enforcement, and litigation. Like other risks, environmental liability risks become more manageable if they are better understood.

Environmental risk management in the context of a transaction starts with the quantification of those risks that can be quantified and the identification of the kinds of risks not subject to quantification, so that at least qualitative judgments can be made about them. If the parties are able to achieve a common understanding of the underlying environmental issues and the associated risks, their negotiation of how to allocate those risks among the parties may be more effective. In any event, each of the parties is well-served to understand the risks that it faces and to make a business decision about what kinds of risks to assume. Ideally, the decisions of the parties constitute a "meeting of the minds" that forms the basis of a contractual risk allocation. Negotiations and drafting of the transaction documentation can then be directed toward implementation of those agreements in principle. Uncertainty about risks, miscommunication and inattention, as well as varying party perceptions of risk and the appetite to incur it, routinely complicate the process of making the deal as to allocation of environmental liability risks. These factors may also lead to surprises during and after the consummation of a transaction.

As with any other liability issue in a business transaction, both lawyers and business principals ought to understand the nature of the liability risks to collaborate effectively in their assessment and management. With limited exceptions, such as crime (where the lawyer can have an affirmative ethical obligation to avoid abetting a crime, such as failure to report to the proper governmental authorities a release of a hazardous substance,[1] and in some circumstances, such as defined in the Sarbanes-Oxley federal legislation with respect to securities-related disclosure, where the lawyer may, in circumstances of corporate disregard "of a material violation of securities law or breach of fiduciary duty" or similar violation, have an obligation to make a "noisy withdrawal"[2]), the business principals ought to have the lead in decisions about assumption of risks, and the lawyers should both develop and provide information used in making the risk assumption decisions and assist in their implementation by negotiation and drafting of transactional documentation. Unlike many liability issues associated with a transaction, however, to understand environmental risks adequately, both lawyers and business principals may require the assistance of a variety of specialized engineers, technicians, scientists, accountants,

1. 42 U.S.C. §9603(b) is an example of a statutory provision for criminal liability in the event of failure to make timely reporting.
2. 15 U.S.C. §7245.

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appraisers, and economists. These professionals are often essential to understanding the nature of the risks that can be quantified, as well as those risks the magnitude of which remains uncertain.

The lawyer's special tasks are to employ the lawyer's understanding of the legal frameworks to ensure that the appropriate environmental professionals are involved in the diligence process, that their findings are put to good use, and that the technical knowledge is integrated with the lawyer's insights about the application of the relevant legal and administrative frameworks. A lawyer conversant in these tasks can contribute to establishment of a robust transactional structure that supports the parties' aims, while increasing certainty about the consequences of contingent liabilities, including in particular who bears them, should they in fact be incurred. The aim of this Article is to provide a lawyer a conceptual orientation and tools helpful to achieving this objective.

II. CERCLA, RCRA, and Other Scary Laws

Although a wide variety of norms established by all levels of government, including local, state, federal, and even supranational bodies, that address standards, procedures, disclosures, permitting, clearances, and liability allocation, can be relevant to the definition of environmental liabilities pertinent to a transaction, the breadth of application of the liability regime associated with hazardous materials and hazardous waste makes the key features of this regime particularly helpful to have in mind while considering approaches to the management of liability allocation in the context of transactions. Although the discussion that follows references United States federal law, it should be kept in mind that the federal law discussed preserves the ability of states to impose additional, more stringent requirements.[3]

This brief sketch of environmental laws deals with hazardous waste and hazardous substances. This is not to minimize the importance of air and water pollution laws, environmental impact and assessment laws, wetlands regulation, land use requirements, occupational health and safety norms, and a whole host of other environmental norms adopted at all levels of government that may also be relevant to a particular transaction. Such laws are just as likely to give rise to liability concerns as the hazardous substance and hazardous waste laws, and they should not be overlooked. Issues presented under such laws may materially impinge on the value of what is at issue in a transaction. Further, failure to comply with them may well give rise to material civil or criminal penalties, and may jeopardize the ability to complete a transaction.

A. *CERCLA Overview*

The federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)[4] of 1980, as amended, also known as the Superfund law, received its name by virtue of its initial provision for an $8.5 billion fund that federal authorities could use to pay the cost of cleaning up release of hazardous substances. Federal authorities could accomplish cleanup with this money and then attempt to replenish the fund by recoveries from the parties responsible for the contamination.[5] Of course, CERCLA also provides tools outside the fund to achieve remediation of releases of hazardous substances. Specifically, it gives the federal government the authority to require any of the parties defined as responsible by CERCLA to accomplish the cleanup.[6] And, ordinary citizens can act as private attorneys general to enforce CERCLA's mandates against potentially responsible parties and against government regulators.[7]

CERCLA pertains to "hazardous substances,"[8] a term that it defines to include substances designated pursuant to the major federal environmental statutes as well as CERCLA itself. In particular, it includes the open-ended definition of substances categorized as hazardous waste under the Resource Conservation and Recovery Act (RCRA),[9] discussed below, that includes substances that are toxic, ignitable, reactive, or corrosive.

Perhaps the most important and enduring provision of CERCLA for counsel to transaction parties is the law's imposition of environmental cleanup responsibility on multiple parties.[10] Such parties include the present owner or operator of the facility at which hazardous substance contamination is located, the generator or the transporter of the hazardous substance that has been released to the environment, and any owner or operator of the facility at the time the hazardous substance was released. The imposition of liability is an imposition of strict liability, without regard to concepts of negligence or fault.[11] These parties are jointly and severally liable in the first instance. That is, the government can decide which, if any, of them to pursue for the whole amount. Only in the second instance may the various responsible parties allocate liability among themselves according to contract or tort principles. In the context of a transaction, the diligence inquiry focuses not only on quantification of the joint and several liability that may exist, but also on the extent of assumption of liability of third parties, or transfer of ultimate liability to third parties, by contractual indemnification.

Of concern to an acquirer or a prospective lender in the context of a transaction is the extent to which CERCLA liability can be limited. Although CERCLA permits third-

3. 42 U.S.C. §§9614(a) and §6928, so providing in the case respectively of the CERCLA and RCRA frameworks.

4. 42 U.S.C. §§9601-9675, ELR Stat. CERCLA §§101-405.
5. 42 U.S.C. §9604.
6. *Id.* §9606.
7. *Id.* §9659.
8. *Id.* §9601(14).
9. 42 U.S.C. §§6901-6992k, ELR Stat. RCRA §§1001-11011.
10. 42 U.S.C. §9607.
11. *Id.* §9601(32).

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party indemnification for CERCLA liabilities, an acquirer would of course prefer an absolute defense to CERCLA liability. Absolute defenses available under CERCLA include acts of God and war, and acts of third parties to whom the defendant is not contractually related.[12]

There are demanding prerequisites under CERCLA to use of the absolute defense that contamination subject to remediation is associated with acts of third parties to whom a party is not contractually related. CERCLA requires as a prerequisite to use of the defense that in the context of a transaction the acquirer prior to consummation of the purchase have carried out "all appropriate inquiries . . . into the previous ownership and uses of the facility in accordance with generally accepted good commercial and customary standards and practices . . . ."[13] What constitutes adequate inquiry under this standard is addressed in the following sections of this essay on due diligence investigation and the engagement of environmental consultants. Moreover, except for a purchaser falling within the definition, introduced into CERCLA by amendment in 2002, of a Bona Fide Prospective Purchaser (BFPP), any knowledge or reason to know of contamination at a facility on the part of the acquirer vitiates the ability to use the defense.[14]

A BFPP may purchase a property without liability for contamination that it knows at the time of purchase is arising from the property if it has in fact established itself as a BFPP by compliance with a number of statutory requirements, notably the completion of "all appropriate inquiries."[15] However, the BFPP remains subject to an eventual lien of the U.S. Environmental Protection Agency (EPA) for costs of cleanup incurred by EPA that increase the value of the property.[16] Moreover, an owner of property with known contamination must disclose the problem to any potential purchaser.[17] Accordingly, even if not liable for the cleanup cost, the owner of such a property holds an asset of diminished value.

B. *RCRA Overview*

Another statute of general transactional concern is the federal RCRA, which deals with the ongoing production of hazardous waste. It creates a permitting scheme for those who treat, store, or dispose of hazardous waste.[18] Under RCRA, the federal EPA lists specific substances as hazardous wastes, as well as establishes definitions of hazardous waste that have open-ended application, including pursuant to criteria of toxicity, ignitability, reactivity, and corrosivity.[19] Associated with this regulatory scheme is a so-called cradle-to-grave manifesting system.[20] That is, a generator of hazardous waste, when sending it for disposal, must provide a manifest in multiple copies to the transporter, who must sign for it and return a copy to the generator. The transporter then takes the waste to a "treatment, storage or disposal facility," which may be a landfill or an incinerator. The recipient signs for receipt of the waste, and copies of the manifests go back to the generator and into federal or state records. In theory, it is possible to trace waste many years after its generation and disposal.

This system implements the statutory policy that a generator of hazardous waste remains liable for it for all time, including for any expenses of its cleanup or management, even many years after its disposal. Of course, as already noted, this is liability in the first instance. It may be that another party contractually assumes liability for a particular waste. For example, the generator may have a contractual claim for reimbursement of cleanup costs from the transporter or the disposal facility.

RCRA empowers the federal government to impose significant penalties for knowing violation of RCRA and for "knowing endangerment," as well as providing it authority to act in case of "imminent hazard."[21] RCRA also empowers ordinary citizens to act as private attorneys general against both violators of RCRA and EPA.[22]

III. Transaction Structure

A. *Stock Versus Asset Purchase; Corporate Structure*

A benefit of a corporate entity to its owners is to shield them from liabilities incurred by the corporate entity in the conduct of its business. To achieve this benefit of a corporate veil, the owners must ensure that the corporate entity satisfies the formalities imposed by the law as a condition to the due constitution and the maintenance of the good standing of the entity with the state authority that permitted its creation. Courts have available various grounds, such as the common-law doctrines of *alter ego*, agency, and *respondeat superior*, to find that the protection of a corporate veil is not afforded.

In the United States, common corporate entities are corporations and limited liability companies, created pursuant to state law by registration with the Secretary of State of the relevant state. The Full Faith and Credit Clause of the U.S. Constitution allows an entity created under the law of one state to operate with the benefit of its corporate veil throughout the United States. Delaware, because of the quality of its corporate legislation and its courts, is a frequent choice as a jurisdiction of incorporation. The ownership interests in a corporation are represented by stock, whereas the ownership of limited liability companies is represented by membership interests.

12. *Id.* §9607(b).
13. *Id.* §9601(35)(B)(I).
14. *Id.* §9601(35)(A).
15. For a recent denial of BFPP status, see *Ashley II of Charleston, LLC v. PCS Nitrogen, Inc.*, ___F. Supp. 2d ___ (D.S.C., 2010), 2010 WL 4025885.
16. 42 U.S.C. §§9601(40) and 9607(r).
17. *Id.* §9601(35)(C).
18. *Id.* §6924.
19. *Id.* §6921.
20. *Id.* §6922.
21. Respectively, 42 U.S.C. §6928(d), 42 U.S.C. §6928(e), and 42 U.S.C. §6973.
22. 42 U.S.C. §6972.

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1. Benefits of a Stock or Membership Interest Purchase

A risk of purchasing the ownership of a corporate entity, particularly one that has existed for some period of time, is that the entity may have liabilities that have not been fully recognized. However, to purchase the stock of a corporation (or the membership interests of a limited liability company) rather than the assets of a corporation (or a limited liability company) generally accomplishes a simplification of the requirements pertaining to environmental permits. The source of the difference is that a purchase of the stock of the corporation generally leaves the identity of the permit holder unchanged. However, some permits, such as for example those associated with nuclear power or with air emissions in areas designated for prevention of significant deterioration of air quality, may include restrictions on change in control of the permit holder that would require administrative procedures substantially similar to those associated with a transfer of the permit from one entity to another, or indeed issuance of a new permit.

2. Benefits of an Asset Purchase

A purchase of assets may limit the extent to which liabilities of the seller, especially liabilities not related to the assets at issue, are transferred to the buyer. In particular, environmental liabilities of the seller unrelated to the assets acquired might be left with the seller. To purchase a business by acquiring the stock or the membership interest of the entity through which the business has been conducted is to acquire all the assets of the business and all the liabilities that the entity may have incurred in the course of its entire existence. Asset purchase constitutes an attempt to select which assets and which liabilities to acquire. This is in contrast to the purchase of the ownership of a corporate entity, where the corporate entity would maintain after the transaction whatever liabilities it had prior to the transaction.

However, common-law doctrines of successor liability are likely to frustrate the effort to assume only selected liabilities if indeed the purchaser acquires substantially all the assets of a corporation or of a limited liability company. Indeed, a June 13, 1984, memorandum from EPA endorses the "*de facto* merger" exception pursuant to which EPA announced its intent to seek to impose CERCLA liability on successor corporations in situations where a corporation acquires substantially all the assets of another company and continues the business of that company in substantially the same manner as before the acquisition. This position builds upon well-established common-law doctrines of successor liability pursuant to which a purchaser of substantially all the assets of a business cannot escape responsibility for the liabilities associated with the conduct of that business.

Moreover, certain state laws, such as New Jersey's pathbreaking Environmental Clean Up Responsibility Act (now the Industrial Site Recovery Act), completely disregard the distinction between stock and asset purchases and impose assessment and cleanup obligations on all transferors of many categories of industrial property. Indeed, in connection with covered transactions, the New Jersey law requires at the time of property transfer the establishment of insurance or bonding to cover the costs of cleanup.

Further, many environmental norms, especially as mentioned in the areas of hazardous substances and hazardous waste, are framed in terms of "owner and operator liability." By adding a substantive notion of "operator" as an alternative path to liability in addition to the more formalistic notion of "owner," they increase the difficulty successfully to employ a corporate form as a shield to broader liability. The concept of owner and operator liability builds on the common-law doctrines of *alter ego*, agency and *respondent superior*, themselves respectively tools for piercing the claim of a corporate veil based on failure to respect the formalities required for constitution of the corporate entity and based on concepts of the law of agency, whereby a principal is responsible for the acts of an agent with apparent authority.

3. Corporate Structures

A separate corporate entity established as a subsidiary focused on a specific business activity might be employed in order to attempt to insulate assets outside the special purpose vehicle from future environmental claims. For example, a separate subsidiary might be established to own land that presents contamination issues or to conduct an environmentally risky business. However, even a subsidiary fully satisfying traditional corporate veil doctrines may not insulate owners under CERCLA. There is a risk that environmental liability may be asserted against owners or even lenders who "operated" the business as a result of intrusion into the subsidiary's business decisions and other failures to maintain "arm's-length relationships" that respect corporate separateness.

In 1998, Justice David Souter, on behalf of a unanimous U.S. Supreme Court, answered the question of "whether a parent corporation that actively participated in, and exercised control over, the operations of a subsidiary may, without more, be held liable as an operator of a polluting facility owned or operated by the subsidiary." The Court's answer was "no, unless the corporate veil may be pierced." The Court went on to observe that "a corporate parent that actively participated in, and exercised control over, the operations of the facility itself may be held directly liable in its own right as an operator of the facility."[23]

More broadly, the circumstances in which a subsidiary corporation would be considered to be operated by its parent remain fuzzy, notwithstanding the many instances of case law that have imposed liability on a parent corporation in connection with activity of a subsidiary not kept sufficiently separate. Thus, it is possible that a parent that failed to pay adequate attention to the maintenance and documentation of arm's-length relationships with its sub-

23. United States v. Bestfoods , 524 U.S. 51, 28 ELR 21225 (1998).

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sidiary could be held liable, beyond the value of its capital investment in the subsidiary, for the subsidiary's environmental liability.

B. Debt Versus Equity

An equity interest in a business means an interest in the upside of the business activity. A debt claim against a business means a claim to repayment of the principal amount of a loan disbursement, plus an agreed return of interest.

Debt and equity interests in fact exist along a spectrum, of which the classic examples of a share of common stock and a straightforward loan are the extremes. Along the spectrum between them, there are many kinds of interests, sometimes structured as tradable securities that blend the characteristics of debt and equity. This blending occurs by combining the characteristic features of each, e.g., preferred stock that enjoys a fixed rate of return in priority to other dividend distributions, and by enabling an instrument to be converted from a nominal debt instrument into an equity interest, e.g., a bond convertible into stock on the happening of certain triggers, or a loan secured by assets sufficient to sustain a business activity.

From an environmental liability perspective, both debt and equity interests have their advantages and disadvantages. Debt claims tend to benefit from an equity cushion. They also benefit from a more passive status. That is, holders of debt are less likely than holders of a dominant equity interest to be tarred with the brush of running the business in ways that might give rise to environmental liabilities by virtue of decisions made relative to the business. On the other hand, it may be more difficult for a holder of debt to assure that the business is well-run to avoid the business' incurrence of environmental liabilities that might frustrate repayment of the debt.

C. Risk-Mitigation Mechanisms

1. Contract Provisions

A variety of contractual provisions may reduce environmental risks, subject to the limitations that contractual agreements (i) will probably not bind government regulators, (ii) are unlikely to affect the rights of private third parties, and (iii) are subject to the financial soundness of the party obligated to stand behind their performance. Relevant kinds of contract clauses include representations and warranties, covenants, indemnifications, and specific allocations of future liabilities resulting from past activities or preexisting contamination. A warranty that the buyer diligently conducted such investigation as it does prior to closing a transaction, for example, may help a seller in defending against buyer claims in the event of post-transaction discovery by the buyer of environmental liabilities. More broadly, representations and warranties regarding specific environmental concerns may help a buyer by allocating the risk of their existence to a seller, or at least triggering a disclosure of their existence by the seller prior to consummation of the transaction. Contractual indemnifications by one party of others may be general or tailored to cover specific environmental liability concerns. Frequently, representations, warranties, covenants, and indemnifications are present in both specific and general forms.

2. Disclosure

Representations and warranties are often drafted to obtain the disclosure of any reports of hazardous waste found or disposed of on the premises, as well as the description of the types of materials used or disposed in conjunction with any industrial or waste disposal activities. They are also routinely drafted to trigger disclosure of material environmental permits and clearances, as well as enforcement issues. More broadly, representations, warranties, and covenants are often drafted to assure that all parties benefit from a common base of information about environmental conditions and liabilities.

3. Prior Agreements With Regulatory Authorities

If compliance problems have been identified and it appears regulatory problems will continue into the future, the parties in many instances address whether to approach appropriate authorities prior to consummation of the transaction in order to agree on a future compliance plan. The risks and potential benefits of such contacts should be thoroughly analyzed in advance of any contact; indeed, any contact should in general be previously authorized by all concerned. For example, if a facility is hopelessly behind schedule under a consent order and a permanent injunction is possible, it might be beneficial to negotiate with the company and regulators a revised schedule for meeting site cleanup goals.

4. Insurance Coverage

Insurers who fail to assess risks and then charge intelligently to cover them would likely not long remain in the insurance business. Accordingly, specific risks that are either fully quantified as significant or that are poorly understood may be quite expensive to insure. Indeed, the premium to cover a fully quantified risk would be in an amount at least equal to the quantification. Insurance, however, can be a useful attempt to minimize potential future environmental liabilities, e.g., insurance to cover the risk of future additional hazardous material release cleanup responsibilities or toxic tort liability.

5. Escrow or Holdback

Establishment of an escrow, deferred payment, earn-out, or similar holdback arrangement to reserve against known, unknown, or contingent liabilities may be a useful tool.

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Such reserves can be structured with thresholds, deductibles, caps, and sharing arrangements on various time lines to incentivize in specific instances the alignment of party objectives in ways consistent with consummating a deal in the face of uncertainty and also conducting the management and solution of outstanding environmental matters as efficiently as practicable. For example, a buyer and a seller might agree to placement of a portion of a purchase price into an escrow account to fund the buyer's accomplishment of an environmental remediation, with unused funds to be shared between buyer and seller, but subject to a partial or full seller indemnification of the buyer for costs in excess of the escrowed amount.

IV. Tools of Duly Diligent Inquiry

Environmental diligence issues are among the most complex and important of investigations and assessments of liability in conjunction with a transaction. A transaction party and its counsel can obtain comfort from a variety of sources that the assumptions upon which the transaction party bases its analysis are in fact correct. The counterparty of course customarily makes factual representations in the transaction documentation. Certificates of experts, such as architects and engineers, on factual matters are commonly provided. Review of permits and other authorizations from governmental authorities, including building permits, certificates of occupancy, and environmental permits, provides further comfort.

A. Due Diligence and Environmental Consultants

Investigation as part of the due diligence process serves as a foundation of efforts to ascertain the risk of environmental liability. The environmental diligence issues are in part legal and in part factual. Lawyers, with respect to diligence issues, are quite competent to probe into legal matters. They are less competent to probe into factual matters that may turn on such disciplines as architecture, chemistry, biology, engineering, geology, hydrology, and materials science. An environmental consultant may be needed to undertake such inquiries.

The environmental consultant's activities are not a substitute for the lawyer's due diligence. The same kinds of queries that a lawyer routinely poses about litigation, contractual obligations, administrative authorizations, and so forth in nonenvironmental areas should be asked in the environmental area. It is appropriate for a lawyer directly to seek an understanding and mastery of environmental liability issues associated with a particular transaction. However, the benefits of engaging an environmental consultant include its abilities to inspect, sample. and test property and other assets, to apply its expertise in connection with particular industrial or manufacturing activities, and to evaluate technical and scientific concerns. It may also have greater familiarity than the lawyer with regulatory practices and enforcement policies.

Government and trade protocols and standards for environmental diligence inquiries exist. Sometimes voluntary, sometimes mandatory, they establish minimum thresholds of inquiry, as well as best practices. ASTM International, for example, is a voluntary standards development organization. Founded over a century ago as the American Society of Testing and Materials, its environmental standards for various purposes are numerous. In the environmental diligence area, its standards—E1527, Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process, and E1528, Practice for Limited Environmental Due Diligence: Transaction Screen Process—have been critical to purchasers, sellers, and lenders in transactions that involve real property assets and operating businesses. Indeed, to qualify for the benefit of BFPP status under CERCLA, a timely ASTM Phase I satisfying its standard ASTM E1527-05 is confirmed by federal regulation as an essential element of establishing that "all appropriate inquiry" into the condition of the property has been undertaken.[24] Further examples of standards developed through industry associations are the Equator Principles, widely adopted in the international banking community to support the conduct of project finance lending in "a manner that is socially responsible and reflect[s] sound environmental management practices."[25]

Some business actors have further specific policies on the kinds of diligence that should be done. The idea is a good one. Such a policy might state for example in the case of a lender, that the lender should not extend credit in connection with property that might be contaminated unless an environmental consultant from a prequalified list has actually performed tests sufficient for such a consultant to form a responsible professional opinion of the risk of contamination.

Environmental consulting is a competitive, service-oriented business. Frequently, it is possible to find environmental consultants who have not only a good technical background, be it engineering, chemistry, biology, geology, or whatever, but who also have some business or legal experience. Desirable environmental consultants should be able to quantify problems realistically and to identify areas of uncertainty. An environmental consultant should help frame issues so that the business people in a transaction can be adequately informed about risks. Once so informed, the business people should make a business decision about how much risk to assume and how to allocate risk among the parties involved.

Frequently, the lawyer rather than the client retains the environmental consultant. The reasons for such an arrangement include the lawyer's ability to direct the environmental consultant's focus on areas of investigation that can help to elucidate factual issues underlying potential legal liability concerns, as well as increasing the likelihood of preserving the confidentiality of the consultant's work. The privilege arguments are, however, generally weak.

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24. 40 C.F.R. §312.11.
25. *See* http://www.equator-principles.com.

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If the consultant's work is done under the direction of an attorney and in anticipation of litigation, the attorney work-product privilege may apply. Ordinarily, however, the probability of litigation, be it with a borrower, an environmental regulator, a counterparty to a purchase or sale, or some other party, is sufficiently remote that such a privilege argument would not likely prevail. Moreover, any claim of privilege would not trump the applicability of the many statutory and regulatory mandates for reporting to governmental authorities environmental issues of various kinds. It is possible, although not certain, that the privilege could be maintained for consultant work product prepared for a prospective borrower concerned not only to demonstrate its credit worthiness and the value of its collateral, but also its liabilities with respect to enforcement and third-party claims, even after the consultant's report is disclosed to a lender, if appropriate precautions are taken to preserve its confidentiality, and if such disclosure is a commercial necessity.

The concern for maintaining confidentiality of the consultant's work is that a consultant's attempt to provide candid information about a party's environmental liabilities might result in the production of information that could be used in an adverse way by hostile parties. To the extent that regulators are already informed, or are required by law to be informed, about environmental problems, concerns about confidentiality of the consultant's work are diminished.

Transaction parties such as lenders sometimes adopt a policy that a consultant should not be allowed to write anything down until it has made an oral report to the supervising attorney or business person. Only after the gist of the report is approved is the consultant permitted to prepare a written draft. Whether one insists upon such a policy depends upon one's confidence in the individual consultants involved. Its rationale is to avoid that a consultant create ill-considered writings that perhaps suggest a problem or concern when in fact there is none. Often a consultant may be quite familiar with technical matters, but not adequately understand the legal and business issues involved. The consultant may also benefit from the application to draft work product of a lawyer's skills in writing and verbal presentation.

The kind, breadth, and depth of investigation that an environmental consultant should undertake depends upon the timing of, and the threshold of materiality in, a particular transaction. The environmental consultant may be asked to provide an overall assessment of the risk associated with a transaction, an asset, or a borrower, or to focus on specific issues of concern. The environmental consultant will typically visit certain or all facilities involved, and review hazardous waste manifests, environmental audit reports, permits, real property title records (to determine past use of real property), and other government and private records, as well as to attempt to understand generally the environmental implications of the activities associated with the proposed transaction.

Environmental audit reports, if they exist, are especially useful. Many companies have instituted environmental auditing programs, performed typically not by accountants, but rather by environmental compliance experts, including consultants and lawyers. Essentially, environmental consultants or in-house compliance staff systematically verify the status of all permits, the adequacy of management practices, and so forth. Such reports may be prepared as part of an enterprise's efforts to comply with best environmental management practices, such as the ISO 14000 norms of the International Organization for Standardization. They may also be prepared as a result of holding in mind the benefits of their demonstration of a proactive approach to environmental compliance in the event of an enforcement action. EPA, for example, maintains a policy of mitigating, or at least not aggravating, compliance actions and penalties if an enterprise is disclosing a violation as a result of an internal environmental compliance auditing program.[26]

Environmental consultant assessments of facilities involve two kinds of issues. One set relates to whether the consultant sees risks associated with ongoing operations, in essence addressed in association with a compliance audit. Another set of issues relates to the condition of soil and groundwater, either on or off both presently and formerly owned premises. Frequently, there will be a question about whether testing or sampling is appropriate. If the consultant does not dig some holes or review existing studies with similar information, assertions about what is or is not present in the ground may be considered guesses, as opposed to judgments based on adequate information. How this issue is addressed will depend on the specific transaction, party perceptions of risk, and the threshold of materiality relevant to the transaction.

Property owners are often aware of these "sleeper" environmental liabilities. Either hazardous substances have been released on their present or former property, perhaps in complete conformity with the law at the time, but the standards have now been tightened, or the property owner knows that it has disposed of waste offsite but lacks precise knowledge of the liabilities associated with the waste that was generated. Virtually every long-established industrial company has this significant environmental liability risk and might receive at any time a communication announcing that barrels bearing the company name have been found in a condition or place requiring remediation.

Many companies take a risk-management approach to such issues. That is, with respect to a project, a construction project for example, or with respect to their ongoing operations, they will attempt to understand the environmental risks to prevent exacerbating an existing situation or creating a new problem. They will focus less on ascertaining the condition of their undisturbed property. However, a lender extending credit, as well as a purchaser of assets, clearly wants to assure that such an inquiry is undertaken, so that it does not unwittingly assume hidden liabilities.

26. U.S. EPA's *Final Policy Statement* (FRL 6576-3), effective May 11, 2000, updating EPA policy maintained from the 1980s.

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B. The Environmental Consultant's Opinion Letter: Beyond an Environmental Audit

The parties to a transaction turn to environmental consultants to investigate the physical conditions and regulatory postures that contribute to determining the nature and amount of environmental liability. The environmental consultants' work, sometimes known as an environmental audit, that is the foundation of this negotiation, needs to be intelligible and complete. This section focuses on a tool, the environmental consultants' opinion letter, that can be used to focus the environmental consultants' work and to clarify its significance.

1. Scope of Opinion

The environmental consultants' opinion letter is a tool to promote intelligibility and completeness of the consultants' investigation. A well-drafted environmental consultants' opinion letter will recite the kinds of investigation that the consultants have undertaken. The letter will then state the consultants' opinion of the adequacy of that investigation, i.e., of the kinds of information such an investigation would or would not reveal. After these preliminaries, the letter should briefly summarize the consultants' conclusions on the environmental liabilities involved.

These conclusions should be specific and, to the extent possible, bounded. Bounded conclusions are ones that attempt to quantify liabilities to the extent possible. That is, to the extent the liabilities cannot be precisely quantified, the consultants should attempt to indicate probabilities of liabilities being incurred and likely and worst-case scenarios. Clear statement of any uncertainties in these conclusions as the result of limited information is appropriate and important.

The parties who have engaged the environmental consultants will rely upon the professional judgment of those consultants to determine what topics the opinion letter should cover. If the environmental consultants protest that they have only been engaged to perform specific, limited tasks, it is appropriate to request them to declare how the limited scope of their engagement requires them to qualify their opinion. If the qualifications are unacceptable, the parties may wish to broaden the scope of the consultants' engagement.

The consultants should state in the opinion letter their standards of what constitutes a material environmental liability. Guidance on this point from the parties and their counsel, who are likely better to understand the financial aspects of a transaction, is appropriate. Indeed, clear direction on what the parties consider material may greatly simplify the consultants' work by enabling them to minimize the amount of investigative effort devoted to smaller matters.

In larger transactions, the consultants may not have the opportunity, or it may not be cost effective, to perform environmental audits on all locations. Questionnaires of individual facility environmental or other management employees and telephone surveys may be the only means of obtaining information. The consultants will need to use their business judgment to determine how reliable such information is and what judgments can be formulated based upon it. The trade offs associated with this kind of investigation should be set forth in the opinion letter.

Topics that are generally covered by an environmental consultants' opinion letter include the risks of liabilities in connection with hazardous substances and hazardous wastes and the risks associated with lack of permits or failure to comply with permits.

Many industrial activities require the routine use of hazardous substances, such as solvents, degreasers, and motor fuel. Hazardous substances in building structures, e.g., asbestos, and equipment, e.g., polychlorinated biphenyls in electrical equipment, may also be of concern. Environmental contamination, health concerns, cleanup costs, and the costs of additional control equipment and changed work practices are hazardous substance issues that the consultants may address.

Liabilities associated with waste disposal practices, especially with respect to offsite disposal, may be difficult to quantify. Information about past waste disposal practices may not be readily available. Many companies learn of their liability only when they receive a communication from an environmental regulator that wastes identified as having been produced by the company, perhaps in the distant past, have been found in a condition requiring remediation. The environmental consultants may nonetheless be able to quantify to some extent the liability risk by analyzing the characteristics of the waste streams involved, by reviewing what information is available about waste disposal practices, and by extrapolating from the company's current experience with environmental claims.

The consultants will ordinarily also address the adequacy of permits held and of compliance with those permits. Failure to comply with permit requirements may lead to significant fines and penalties, as well as to interruption of business activities. An assessment of the likelihood that more stringent future regulatory standards may impose additional costs is also common.

2. Investigation Elements

Environmental consultants undertaking assessment of environmental liabilities will often propose to define their work with respect to a recognized industry protocol, such as those affirmed by ASTM International. Such protocols are often sound and, as mentioned in connection with establishing BFPP status, even essential, baseline points for the definition of consultants' scope of work, but they should not limit demands for consultant expression of judgment as to their appropriateness and limitations in any given context.

A great deal, although by no means all, of the environmental consultants' work can be done without visiting the

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property involved and without alerting either its present owner or regulators to the consultants' interest in a site. Permits, real property ownership records, geological and hydrological data, and aerial photographs are among the kinds of information publicly available on an anonymous basis. Review of this information may provide substantial information about the liabilities associated with a property. However, important and often essential additional information may be obtained by site inspections, onsite sampling of soil and groundwater, and interviews of regulators and individuals familiar with the site.

Because of the variety of kinds and intensities of investigations that might be undertaken, it is important that the consultants' opinion letter review summarily the investigations actually performed and their significance. Sometimes, because of time constraints or sensitivities of the parties, it may not be possible to have complete onsite investigations. Based on what is learned from review of publicly available information and whatever other investigation is performed, the environmental consultants' opinion letter should make clear the risks associated with not having performed the onsite investigations or with having taken only limited samples for laboratory analysis.

As is the case for legal opinions, environmental consultants' opinions should not be last-minute matters. That is, a draft of the opinion should be prepared early on as a tool for clarifying to all parties the environmental consultants' understanding of their task. Review by the parties and their counsel of the environmental consultants' opinion early in the preparations for consummation of a transaction provides an opportunity to ensure that the environmental consultants' efforts are properly directed.

Because the consultants' physical and regulatory investigations will often overlap with the lawyers' due-diligence investigations into ownership, litigation, contractual liabilities and other matters, it is helpful to use drafts of the consultant's opinion letter as a vehicle for clarifying additional areas that the lawyers' due diligence may suggest require investigation. For example, a lawyer's investigation into the contractual liabilities of a company may reveal that the company has by contract agreed to indemnify owners of businesses it once owned for environmental liabilities arising from activities during the prior period of ownership. The draft consultants' opinion letter in such an instance should be revised to include an assessment by the consultants of the nature of such liabilities. Unless it is clear to the consultants early in their work that such liability is legally of concern, they may not have sufficient time to investigate such liability thoroughly.

3. Credibility

a. Choose Credible Consultants

An environmental consultants' opinion letter is only as credible as the consultants rendering it. Accordingly, those engaging environmental consultants should attempt to engage the most competent and reputable consultants available.

Environmental consultants, prior to their engagement, are ordinarily more than willing to provide promotional brochures describing their qualifications and resumes of individuals who would work on a particular matter. Obtaining a commitment that the consulting services will be provided by particular, qualified individuals, or at least under the direction of such individuals, is a useful step in ensuring credibility of the consultants' opinion letter. A further step is to check references, including present and former clients, provided by the consultants.

The technical qualifications desirable for a particular matter will depend upon the circumstances. In some instances, doctoral-level chemists or geologists may be required. In other instances, a general familiarity with the approaches of regulators to specific environmental problems, e.g., underground storage tank leakage, may be what is required. The environmental consultants should be willing to declare and document their competence to perform the services required.

Business judgment is another important characteristic of good environmental consultants. That judgment will be most evident in questions of materiality. In large matters, the consultants will need to know how to abstract from particulars to form a general impression of overall environmental liabilities. Their ability to form an overall assessment, for example, of a company's environmental management program is of value to the client. Likewise, their ability to identify the primary material liabilities in an aggregate sense will require the consultants to abstract from information about specific liabilities. References from past and present clients and evidence of business experience on resumes are sources of information to evaluate in assessing the business judgment of consultants.

b. Ways for Consultants to Stand Behind Their Work

The consultants should be willing to agree contractually to use due care in the performance of their work and, at the very least, not to perform their services in a negligent manner. Even if the consultants are willing to accept statement of such a standard in their engagement agreement, they may wish to limit their liability to the amount of insurance coverage available. Exploring these issues with several consulting firms is a way to ensure that the parties are as well-served as possible in this regard. Many consultants are able to provide $1,000,000 or $5,000,000 of professional errors and omissions insurance. Likewise, consultants retained also to perform remediation, as distinguished from solely investigative work, are often able to provide insurance against environmental liabilities arising from their remedial work.

For small transactions, insurance may provide a meaningful solution to the issue of the extent to which the environmental consultants will stand behind their work.

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For larger matters, however, limitations on the amount of insurance available, as well as the typically low net worth of environmental consultants, may make it impossible to obtain any significant comfort, at least with reference to an amount material to the transaction at issue, from the possibility of recourse against the consultants in the event that services, including the rendering of an opinion letter, are improperly performed.

The solution to this issue of the professional responsibility of environmental consultants is to appreciate that the consultants are not insurers against environmental liability. Rather, they are providers of professional services to identify and quantify environmental liabilities. The contractual requirements that they provide professional services with due care and that they be liable in some nontrivial amount for failure to act with due care, even if only indirectly via insurance coverage, are tools to encourage provision of the services of the required standard. The best protection, however, is to obtain services from experienced and competent consultants with good reputations.

c. Relying on Consultants of Others

The party with the most to lose from inadequate quantification of environmental liabilities should have its own environmental consultants. Ordinarily, that party is the purchaser or lender, because such a party would assume new environmental liabilities by virtue of undertaking the transaction.

In some instances, a seller or borrower will be sufficiently concerned about protecting against improper disclosure of environmental liabilities to regulators and prosecutors, so that it will require that its consultants prepare the report. The environmental consultants' opinion letter may serve as a device for breaking the deadlock over which party's environmental consultants may undertake full-fledged investigations. The parties may be able to agree in advance upon the form of the opinion that the consultants would render if their investigations in fact support such an opinion. The opinion should be addressed to all parties who will be relying on it. In addition to agreeing on the form of the opinion, it may also be possible to agree in advance upon the form of the protocol for investigation that the environmental consultants will be requested to employ in establishing whether there is a basis for them to render the opinion.

Other parties who intend to rely upon the opinion letter of consultants other than their own should have confidence that such environmental consultants will perform the investigations in a thorough and unbiased fashion. The parties' comfort will derive from the reputation of the consultants and the agreements about the forms of the opinion and protocol of investigation. Particularly if the transaction goes forward, the relying parties may require access to the report as a further source of comfort.

V. Disclosure

A variety of special statutory reporting schemes at state and federal levels require reporting to regulators of environmental facts, including the presence of hazardous materials and the occurrence of releases of such materials. Failure promptly to comply with any of these requirements may have serious consequences. The cumulative compilation of these reports is a rich trove of information useful to the assessment of environmental risks. Probing this trove of information is a routine, constructive, and essential part of the work of an environmental diligence team investigating risks in connection with a transaction.

CERCLA, for example, requires that a person in charge of a facility "as soon as he has knowledge of any release (other than a federally permitted release) of a hazardous substance" above defined threshold quantities, report such release to the National Response Center. "[27] The Federal Water Pollution Control Act (FWPCA)[28] has a similar requirement with respect to discharges of oil.[29]

The Emergency Planning and Community Right-to-Know Act (EPCRA) of 1986 contemplates a different kind of reporting. It requires that inventory of substances described by material safety data sheets be filed with fire department and emergency authorities.[30] Among information to be disclosed "for each listed toxic chemical known to be present at the facility" is the following:

(i) Whether the toxic chemical at the facility is manufactured, processed, or otherwise used, and the general category or categories of use of the chemical.

(ii) An estimate of the maximum amounts (in ranges) of the toxic chemical present at the facility at any time during the preceding calendar year.

(iii) For each waste stream, the waste treatment or disposal methods employed, and an estimate of the treatment efficiency typically achieved by such methods for that waste stream.

(iv) The annual quantity of the toxic chemical entering each environmental medium.[31]

Additional federal and state requirements pursuant to environmental regulatory frameworks that mandate reporting of environmental information produce significant further information of interest for due diligence in connection with transactions. Accounting practices and securities law requirements also mandate disclosure of environmental matters and yield yet further kinds of information of interest.

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27. 42 U.S.C. §9603(a).
28. 33 U.S.C. §§1251-1387, ELR Stat. FWPCA §§101-607.
29. 33 U.S.C. §1321(b)(5).
30. 42 U.S.C. §§11021 and 11022.
31. *Id.* §11004(b).

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A. *Securities and Exchange Commission*

The approach of federal securities law to assure well-functioning capital markets in the United States remains that actual and prospective investors receive disclosure of all matters material to an informed decision to maintain or to make the investment. As to any transaction involving a party and securities that have become subject to federal securities law, significant useful information about environmental liabilities of interest may be readily and publicly available through the online databases of corporate disclosures maintained by the Securities and Exchange Commission (SEC). The following sections describe the application of the disclosure philosophy of federal securities law to environmental liabilities.

B. *General Securities Law Disclosure Requirements*

1. Disclosure of Information Material to Investment Decision

Section 10(b) of the Securities Exchange Act of 1934 forbids companies whose securities are registered with the Securities and Exchange Commission:

> to use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[32]

In implementation of this statutory provision, the Security and Exchange Commission's Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[33]

The Securities Act of 1933 imposes liability in connection with the offer or sale of a security by any means that includes "an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading."[34] The Security and Exchange Commission's Rule 405 states:

> The term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security changed.[35]

Its Rule 408 adds:

> In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.[36]

2. Regulation S-K

The Security and Exchange Commission's Regulation S-K provides standard instructions for filing disclosure forms under the 1933 and 1934 Acts, including registration statements and quarterly and annual reports.[37]

a. Litigation

Item 103 of Regulation S-K sets forth the disclosure requirements with respect to legal proceedings.[38] It provides:

> Describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authorities.

Instruction 5 to Item 103 specifically addresses environmental matters. It provides:

> Notwithstanding the foregoing, an administrative or judicial proceeding (including for purposes of A and B of this Instruction, proceedings which present in large degree the same issues) arising under any Federal, State or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primary for the purpose of protecting the environment shall not be deemed "ordinary routine litigation incidental to the business" and shall be described if:
>
> (A) Such proceeding is material to the business or financial condition of the registrant;

32. Securities and Exchange Act of 1934, 15 U.S.C. §78j(b).
33. 17 C.F.R. §240.10b-5.
34. §§12 and 17, 1933 Act.
35. 17 C.F.R. §230.405.
36. *Id*. §230.408.
37. *Id*. §§229.10 et seq.
38. *Id*. §229.103.

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(B) Such proceeding involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges or charges to income and the amount involved, exclusive of interest and costs, exceeds 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis; or

(C) A governmental authority is a party to such proceeding and such proceeding involves potential monetary sanctions, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions, exclusive of interest and costs, of less than $100,000; Provided, however, that such proceedings which are similar in nature may be grouped and described generically.

An SEC no-action letter has taken the position that the term "sanction" in Part C of Instruction 5 does not include the cost of environmental cleanup incurred pursuant to an agreement with EPA.[39] However, cleanup costs may have to be disclosed as "an uncertainty known to management" as part of Management's Discussion and Analysis of Financial Condition and Operations.[40]

b. Compliance

Item 101 of Regulation S-K concerns the description of the business. The relevant environmental portion of Item 101 states:

> (xii) Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material.[41]

c. Environmental Policies

If a company chooses to disclose its policy toward compliance with environmental regulations, the disclosure must be accurate, and further information may be necessary to ensure that the disclosure not be misleading.[42] If a company's policy toward compliance is such that the company is reasonably likely to incur substantial liability or otherwise be significantly affected, the company may need to disclose the likelihood and magnitude of such effects.[43]

C. *Accounting Principles*

The Financial Accounting Standards Board (FASB) is an independent body created in 1973 by the American Institute of Certified Public Accountants (AICPA). The FASB and the AICPA independently put forth financial accounting and reporting standards. Their accounting principles collectively comprise GAAP, meaning generally accepted accounting principles. In recent years, there has been a concerted and sustained effort to converge the accounting standards prevalent in the United States with those in the rest of the world, that generally follows the International Financial Reporting Standards (IFRS). Indeed, companies publicly traded in the United States are increasingly likely to state their accounts in accordance with the IFRS.

The FASB has spoken most pertinently to environmental matters through its Statement of Financial Accounting Standard No. 5, *Accounting for Contingencies* (March 1975). The analogous standard under the IFRS is International Accounting Standard 37, *Provisions, Contingent Liabilities, and Contingent Assets* (IAS 37). Pursuant to each of these standards, financial statements reveal reserves for loss contingencies that are at least probable and the amount of which can be reasonably estimated. As to contingencies that are only at least reasonably possible, financial statements include notes that describe the contingency and provide either an estimate of it or a statement of the inability to do so. A difference between FASB No. 5 and IAS 37 is that IAS 37 requires a reserve for quantifiable liabilities if their likelihood of incurrence is "more likely than not," meaning a greater than 50% chance of incurrence, whereas FASB No. 5's criterion of "probable" is understood as a higher percentage of probability of incurrence.[44]

The FASB has, in recent years, addressed the issue of accounting for environmental liabilities in the context of acquisitions through its Financial Accounting Standard No. 141. This standard focuses on the projection of losses at fair value as distinguished from the approach of FASB No. 5, which focuses on the predictability that a loss will occur. The essence of FASB No. 141 is that companies acquiring contingent assets or assuming contingent liabilities in a business combination must disclose at the acquisition date the fair value of an asset or liability, if it can be determined within a year following acquisition, or simply recognize the asset or liability at fair value as of the date of the acquisition. If such value cannot be determined within a year following the acquisition, they must recognize the asset or liability if it is probable that a liability has been incurred, based on information available within a year following the acquisition, and the amount can be reasonably estimated. If, however, the fair value of a contingency cannot be determined and the contingency is not probable or cannot be reasonably estimated, such a contingency should

39. Thomas A. Cole, SEC No-Action Letter, [1989] Fed. Sec. L. Rep. (CCH) ¶ 178,962 at 78,813 (Jan. 31, 1989).
40. *Id.*; 17 C.F.R. §229.303(a)(3).
41. 17 C.F.R. §229.101(c)(1)(xii).
42. Release No. 6130.
43. *Id.*

44. *Making History: A Look at a Move to IAS 37 From the Longstanding FAS 5 and Its Effect on Buy-Sell Transactions*, Deloitte Financial Advisory Services LLP, *available at* http://www.deloitte.com/view/en_US/us/b59f773b-93912210VgnVCM100000ba42f00aRCRD.htm.

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not be recognized as of the acquisition date, but rather should instead be accounted for in subsequent periods pursuant to FASB No. 5.

VI. Transactional Agreement Provisions

Transactional agreements, whether credit agreements or agreements of purchase and sale, affect the allocation among transaction parties of risk for environmental matters. A significant concern for the reasons discussed above will often be the risk of environmental liability for hazardous waste and hazardous substance matters. The maintenance of permits necessary to generate the revenue stream from which the loan will be repaid or that anchor the value of the property to be conveyed in a transaction is also of concern. Other kinds of environmental liabilities may, in conformity with the result of the due-diligence investigation, also be of concern.

Such agreements should ordinarily be crafted to address environmental matters in light of the information learned during the diligence process. However, even if an agreement never mentions the word "environment," it likely nonetheless still affects the allocation of environmental liabilities among the parties.

For example, warranties that a transaction party has "good, sufficient and legal title to all properties and assets and that all such properties and assets are free of liens" and that "there is no fact known to the party that would materially adversely affect its business, operations, property, condition (financial or otherwise) or prospects" are affirmations by the party of the absence of material environmental liabilities. Likewise, further representations and warranties of the absence of "material adverse change in financial condition, prospects or operations" and that "there is no pending or threatened action or proceeding before any governmental authority which may materially adversely affect financial condition, prospects or operations" also affirm the absence of material environmental liabilities.

The covenants in a transactional document may also speak to environmental matters, even if they do not mention environmental topics expressly. Such covenants might include a party's promises to (1) comply with all applicable laws, rules, regulations, and orders, (2) maintain in good repair, working order, and condition all material properties used or useful in its business and maintain insurance with respect to such properties and business as is customary in the same or similar business, and (3) not permit to exist any lien on or with respect to any of its properties or assets except for specified liens (liens relating to environmental claims being not specifically excepted).

A. *Definitions*

In a transactional agreement, the concept of nasty stuff, whether labeled as "hazardous substances," "contaminants," or "pollutants," is typically important in a number of its operative provisions. Accordingly, a buyer or lender's counsel should try for a broad definition that includes anything that is, or in the future comes to be, considered nasty under CERCLA, RCRA, and whatever other state and federal statutes might be relevant. The contractual definition of these terms is frequently and ideally a combination of generality and specificity.

Typically, these definitions also mention by name a variety of specific kinds of substances, such as petroleum, petroleum products, asbestos, and polychlorinated biphenyls (PCBs). The reason for specific mention is that, under various federal and state laws, such substances are somehow treated specially or excluded from definitions of hazardous waste or hazardous substances. This is in part because of the historical accident of when they came to be identified as a problem and in part because their physical or economic characteristics have led to the elaboration of special regulatory schemes to deal with them.

For example, petroleum is the subject of special treatment in statutory definitions of hazardous waste. As part of oil drilling, petroleum, produced water, and drilling muck are spilled or disposed of in sumps, frequently no more than ditches in the ground. The oil industry was able to achieve the political compromise in RCRA of leaving the regulation of such waste to state law. One of the industry's principal concerns was that the cost of regulation of such waste as hazardous waste under federal law would break the oil industry.

Accordingly, petroleum and petroleum products, drilling wastes, and so forth are often separately mentioned in the relevant transaction agreement definitions. This is appropriate, for example, because a lender making a loan on property where such waste is present, even though it is technically not hazardous waste under federal law, may find the value of its collateral significantly impaired.

B. *Liens*

A number of invisible or hard-to-find environmental liens may be of concern. CERCLA gives rise to a lien on property that has been remediated with money from Superfund.[45] The lien takes priority over other liens from the moment that notice of it is filed in the appropriate office designated by state law, or absent such designation, in the office of the clerk of the court of the United States district court for the district in which the real property is located.[46]

Some state liens may arise in an even more invisible fashion. These liens may be so-called super liens, in the sense that they take priority over all other liens, even properly perfected security interests. In addition, some states may impose a lien not just upon the affected property, but upon all of the assets of the owner of the property. Local counsel should be requested to advise whether a particular state's law gives rise to any such liens.

45. 42 U.S.C. §9607(1).
46. *Id.* §9607(1)(3).

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There are also interesting questions about the priority of these liens in bankruptcy and the priority in general of Superfund cleanup expenses. This complicated subject requires careful consideration if it arises, in part because bankruptcy proceedings will not separate the responsibility for environmental cleanup from specific real property assets that give rise to the environmental liability. That is, even when sold out of a bankruptcy proceeding, a piece of contaminated real property remains diminished in value, at least by the cost of its remediation.

C. *Representations and Warranties*

Many transactions involve multiple steps in the context of an ongoing relationship of the parties. For example, many credit agreements involve repetitive borrowings. Accordingly, it is helpful if the representations and warranties are evergreen, i.e., remade as of each borrowing. If an environmental problem arose, it would prevent the warranty from being made. The lender would then be able to decide whether it wishes to continue to extend credit.

The representations and warranties that counsel for an acquiring party or a lender should seek to include are the standard ones concerning knowledge of pending or threatened litigation or administrative investigations and proceedings, compliance with permits and the law in general, and so forth. There is often a temptation to try for more detailed representations—for instance, a representation that no borrower property has ever been a treatment, storage, or disposal facility. Such a request is an attempt to have the borrower state that its property has never been a hazardous waste dumping ground. Other warranties to be requested may include ones addressing how waste has been disposed of, whether particular substances are used in borrower operations, and whether substances such as asbestos and PCBs are present on the borrower's property.

The desired degree of detail depends on the results of the diligence process. That process may suggest specific issues with respect to which an acquirer or lender should seek comfort from its counterparty. Moreover, if the counterparty's failure to comply with a particular law is likely to give rise to some material liability, requesting a specific representation will focus the party's attention on that law.

Some lawyers prefer quite detailed lists of statutes, regulations, and conditions. The benefit of such a listing is that opposing counsel will verify what each of those items is and that it is indeed reasonable to expect the borrower to comply. In a sense, such a request is an extension of the diligence exercise to assure that the specific points raised by it are attended to. "Including but not limited to" may be useful phrasing.

D. *Materiality*

No matter what level of detail is sought in the representations, it should be tempered by some materiality criteria. That is, in the case of a $200,000,000 loan, a default will not be declared because of the borrower's obligation to spend, say $10,000, to remediate a minor spill of heating oil. It is also useful to keep in mind that hazardous substances are routinely and appropriately used in ordinary operations in all kinds of businesses. Even a well-managed company is likely to have some environmental problems from time to time.

A materiality standard may be formulated vaguely by general references to "materiality" or specifically as an appropriate carve-out of some dollar amount. There is no need to impose an unreasonable straightjacket.

Lack of a materiality standard with regard to environmental aspects of an agreement may lead to counterproductive outcomes. For example, at least one credit agreement required a borrower to remove all asbestos from the collateral. Although the presence of asbestos may seem an objective fact, in many old buildings, the only way to assure the absence of asbestos is to dismantle the entire building. Moreover, if the asbestos is properly encapsulated, it may not be causing any harm whatsoever. In this instance, the lender forced the borrower to bear significant asbestos removal costs, not all of which were beneficial to the lender.

E. *Special Lender Concerns*

1. Covenants

It is appropriate particularly for a lender to have its borrower promise to comply with the law. The lender may seek to have the borrower mention specific laws, regulations, permits, or authorizations with which compliance is particularly important. However, requiring the borrower to promise to operate in a certain way beyond complying with the law may give rise to a risk of the lender's being found to be an operator with all of the associated negative consequences.

It is appropriate for the lender to receive information from the borrower and to have the borrower promise to give the lender information. Such information might include copies of notices received regarding environmental matters, updates of permits, and information as to any reports of the release of hazardous substances made to regulatory authorities. It might include information about fines and other amounts paid as the result of environmental problems. It might include even a requirement that environmental audits and reports be regularly made available to the lender. It may further mean giving the lender the right to hire a consultant at the borrower's expense to investigate environmental matters.

However, by no means should any of this involve the lender in operating the borrower's business, which would require revisiting whether "operator" liability for hazardous materials concerns would apply to the lender under such regulatory frameworks as those of CERCLA and RCRA. The lender should simply be acquiring information, so that it can determine whether to continue to extend credit pur-

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suant to the terms of the credit agreement or whether it has grounds to declare a default.

2. Indemnification

Some credit agreements provide for the borrower's indemnification of the lender for environmental liabilities. There are several reasons to be skeptical of the value of such an indemnification, not the least of which is that if the occasion to rely on it ever comes to pass, the borrower may well be insolvent. To put the point another way, the most likely reason to look to the lender to cover some environmental liability is the borrower's inability to remedy the situation.

Moreover, state law may make the enforceability of such an indemnification problematic. For example, the combination of California's "one action rule,"[47] together with its anti-deficiency law,[48] may block enforcement of such an indemnification agreement. In many instances, the lender's claim for indemnification may arise only after it has already attempted to realize on its collateral. However, the lender's first action to foreclose on the collateral may well be, by virtue of the "one action" and anti-deficiency provisions, its only opportunity to make claims against its borrower. There may be ways around this block, such as the concept of a springing indemnity. However, obtaining an even minimally useful environmental indemnity from the borrower requires thought about how relevant law might affect its enforceability. And in any event, it is also appropriate to consider whether there is any great benefit from such an indemnification.

The issues in a purchase agreement context are different. There, indemnification serves to allocate responsibility and risk among the parties. Such indemnification provisions can become quite elaborate. There can be floors and ceilings, sharing arrangements, time limits on the indemnification, and so forth.

The enforceability of indemnification agreements may in any event be called into question by public policy considerations with respect to the shifting of liabilities. For example, indemnification and insurance arrangements with respect to criminal liabilities and punitive damages are broadly deemed contrary to public policy, and hence not enforceable.

3. Security Interest

When a lender extends credit, it expects to be repaid from funds earned by the borrower. In addition, the lender may look to real property or other assets as collateral.

Contaminated property may be worth far less than the lender contemplated. In addition to diminishing the value of the collateral, the presence of contamination on the property may engender the loss of permits, either those associated directly with hazardous substances or others necessary to operate the borrower's business. In either case, the result may be that the borrower has insufficient funds to repay the loan. It is important that the lender understand the risks of such an event coming to pass. In addition to understanding the risks of hazardous substance liability, a lender contemplating foreclosure should understand whether any material environmental authorizations are subject to restrictions on transferability.

Lender lawyers are broadly familiar with lender liability issues. The general imprudence of allowing even the perception that a lender is running its borrower's business applies very much in the environmental area. The environmental law concepts that could raise a problem are those of so-called owner or operator liability. These concepts exist under CERCLA, RCRA, and their various state analogs.

To facilitate credit transactions, CERCLA provides special exemption from the "owner or operator" concept for holders of security interests. Its definition of "owner or operator" "does not include a person, who without participating in the management of. . . a facility, holds indicia of ownership primarily to protect his security interest in the . . . facility."[49]

Such a person is otherwise exempt from CERCLA's broad imposition of liability for cleanup costs. The parameters of the quoted statutory provision have been defined in the context of judicial decisions in the early days of the federal Superfund law that suggested a lender's mere ability to influence a borrower's management could give rise to cleanup liability.[50] These decisions triggered the issuance of a regulation by EPA that sought to shield a lender from liability in such a circumstance. Following a judicial determination that EPA did not have the authority to resolve the matter by regulation,[51] legislation adopted in 1996 validated the substance of the regulation.[52]

A lender may be tempted to try to protect the value of its collateral against environmental liabilities by strictly limiting the activities of its borrower, or even worse, by making almost any action by the borrower subject to its express approval. Risky lender activities include becoming involved in naming management personnel and approving business activities. The risk associated with a lender's attempt to limit unduly the borrower's actions is that the lender could be construed to be operating, or participating in the management of, the borrower. If that were the case, then the lender would be potentially liable for cleanup costs conceivably greater than the worth of its collateral and the amount of the loan. A lender is similarly at risk if it forecloses on contaminated property, i.e., if it moves beyond the mere holding of indicia of ownership to protect a security interest.

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47. Cal. Code Civ. Proc. §726.
48. *Id.* §580d.
49. 42 U.S.C. §9601(20)(A).
50. *E.g.*, United States v. Fleet Factors Corp., 901 F.2d 1550, 20 ELR 20832 (11th Cir. 1990); United States v. Maryland Bank & Trust Co., 632 F. Supp. 573, 16 ELR 20557 (D. Md. 1986).
51. Kelley v. EPA, 15 F.3d 1100, 24 ELR 20511 (D.C. Cir. 1994), *reh'g denied*, 25 F.3d 1088, 24 ELR 21204 (D.C. Cir. 1994), *cert. denied sub nom.* American Bankers Ass'n v. Kelley, 513 U.S. 1110 (1994).
52. *See* H.R. 4278, 104th Cong. (1996), Asset Conservation, Lender Liability, and Deposit Insurance Protection Act §2504.

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VII. Transactional Environmental Risk Management as a "Win-Win"

Any transaction is necessarily associated with change, and hence stress for all concerned. Concerns about environmental liabilities and their allocation among the transaction parties increase the stress level. However, part of achieving a well-structured transaction, understood as one in which the parties each understand their respective rights and obligations associated with the transaction under the various scenarios that may transpire, is proactive management of the concerns about environmental liability. The approaches of working to establish a common understanding of the potential environmental liabilities and on the basis of that understanding to structure transaction terms that reflect a thoughtful agreement among the parties can increase significantly the likelihood not only of consummating a transaction, but also of consummating a transaction that with the passage of time will less likely produce ongoing contention or surprise among the parties.

The abundant public information available under state and federal regulatory regimes, including environmental regulations, as well as the accounting and business information disclosed pursuant to the federal securities laws, is a resource upon which to draw in undertaking the duly diligent investigations of a transaction and the associated assets and parties. The techniques here described, notably for orienting and directing the work of environmental consultants and for documenting and allocating risk, help to identify and marshal the kinds of information relevant to structuring and consummating transactions in ways that achieve and reflect real understanding and agreement of the parties as to the allocation of environmental risks.