

# Conducting Environmental Due Diligence and Audits

Thompson & Knight



Impact

Creating Value, Benefiting  
from Incentives, and an  
Opportunity to Change the Law

# Environmental Due Diligence and Auditing

- **Why do buyers and lenders conduct environmental due diligence?**
- **What is the primary motivation for conducting an environmental audit?**

**Understand and Manage Risk &**

**Avoid or Limit Liability**

# Types of Environmental Liability

- **Liability for conditions on the property**
- **Liability for offsite conditions caused by the facility**
- **Liability for offsite shipments (CERCLA arranger liability)**
- **Liability for violations of permits and laws governing operations (air, water, solid waste)**
- **Third party claims**
- **Contractual liabilities**

# Who is Potentially Liable for Conditions on Property?

- **Current owner or operator — status liability**
- **Past owner or operator at the time of disposal or release**
- **One who arranges for the disposal**
- **“Operator”**

# Liability — Compliance Issues

- **Owner/Operator**
- **Presumption of continuing violation**
- **Nature of transaction critical to assessment of risk**

# Benefits of Due Diligence

- **Risk Avoidance** – simply avoid facilities that are contaminated or that have significant compliance issues
- **Risk Management**
  - Remediate conditions or bring facility into compliance before closing
  - Address known conditions and risk of unknown conditions in deal terms
  - Utilize regulatory programs and defenses to address conditions and avoid liability

# Due Diligence – Basic Concepts

- **Due Diligence** – One size doesn't fit all.
- **Factors influencing the diligence due**
  - Familiarity with property, past operations, and the conditions involved
  - Level of site development and nature of operations
  - Time and cost considerations
  - Buyer's tolerance for risk and dependence on third parties (lenders)
  - Deal structure and seller's continued existence and viability

# Key Environmental Issues in Transactional Due Diligence

- Onsite conditions and releases (Phase 1 and 2)
- Compliance
- Permits and licenses
- Potential liability for offsite conditions
- Records
- Communications with regulatory agencies
- Environmental management system
- History of prior ownership or operators
- Insurance coverage



# On-Site Conditions- Phase I (All Appropriate Inquiry)

- **Initial Environmental Site Assessment**
  - EPA regulations 40 CFR Part 312 and ASTM Standard E1527-05 is consistent with EPA rule defining AAI
- **Identifies potential presence of environmental contamination based upon records of prior use, reported incidents, neighboring uses, visual observations, and inquiries**
- **Does not involve testing or quantification of risks**
- **Does not address all site conditions or compliance**

# On-Site Conditions- Phase II

- **Testing of soil and/or groundwater**
- **Define the nature and extent of contamination**
- **Determine the “risk” associated with the contamination**
- **Compare findings to relevant cleanup criteria**

# Compliance

- **Permit requirements**
- **Applicable regulatory standards**
- **Audit program and reports**
- **Required program elements**
  - **Sampling and monitoring**
  - **Reporting**
  - **Certification**
  - **Practices and procedures**
- **Orders, citations, NOVs**
- **Threatened or contemplated actions**
- **Compliance agreements, schedules, consent orders**
- **Fines or penalties**
- **Environmental studies**

# Permits

- **Identify all Environmental Permits or Governmental Authorizations**
- **Questions:**
  - **Are the permits transferable and on what basis?**
  - **Does the company have all required permits for the current operation and level of production?**
  - **Is the company in compliance?**
  - **Can amendments be obtained?**

# Due Diligence – Scope of Work

- **Is the ASTM Standard comprehensive enough for your project?**
- **Parties relying on report**
- **Single commercial facility or portfolio of facilities**
- **Radius review – minimum distances**
- **Historical ownership/operations**
- **Acquisition of leasehold interest**



# Due Diligence – Scope of Work

- **Logistics**
  - Organization of records
  - Time constraints
  - Location of sites
  - Availability of escorts
  - Confidentiality
- **Evaluation of environmental permits**
  - Compliance
  - Operational conditions/constraints
  - Transfer requirements
  - Planned modifications



# Due Diligence – Scope of Work

- **Regulatory file review**
- **Previous purchase/sale agreements**
- **Lease agreements**
- **Local land-use and environmental permitting requirements**
- **Current operations**
  - **Continued existence**
  - **New Entity**



# Due Diligence – Scope of Work

- **Future development plans**
  - Major modifications
  - New development
- **Cost of compliance**





# Due Diligence – Getting the specifics in the Agreement

- **Timing of review**
- **Scope of review**
- **Access to property, personnel, records**
- **Access to government agencies**
- **Standards that will be followed**
- **Right to install wells and conduct testing**
- **Right of seller to split samples**
- **Costs – each party bears its own costs**

# Due Diligence – Be Specific as to Consequences

- **Notice of Defect**
  - Level of detail – description, valuation, basis of complaint
  - Timing
- **Buyer's alternatives**
  - Don't close
  - Condition closing on correction
  - Obtain concession on price or exclude the asset
  - Accept with escrow
  - Indemnity

# Due Diligence – Be Specific as to Consequences

- **Seller's alternatives**
  - **Fix it**
  - **Contest existence or valuation**
  - **Adjust price**
  - **Exclude asset**

# Environmental Audit - A Definition

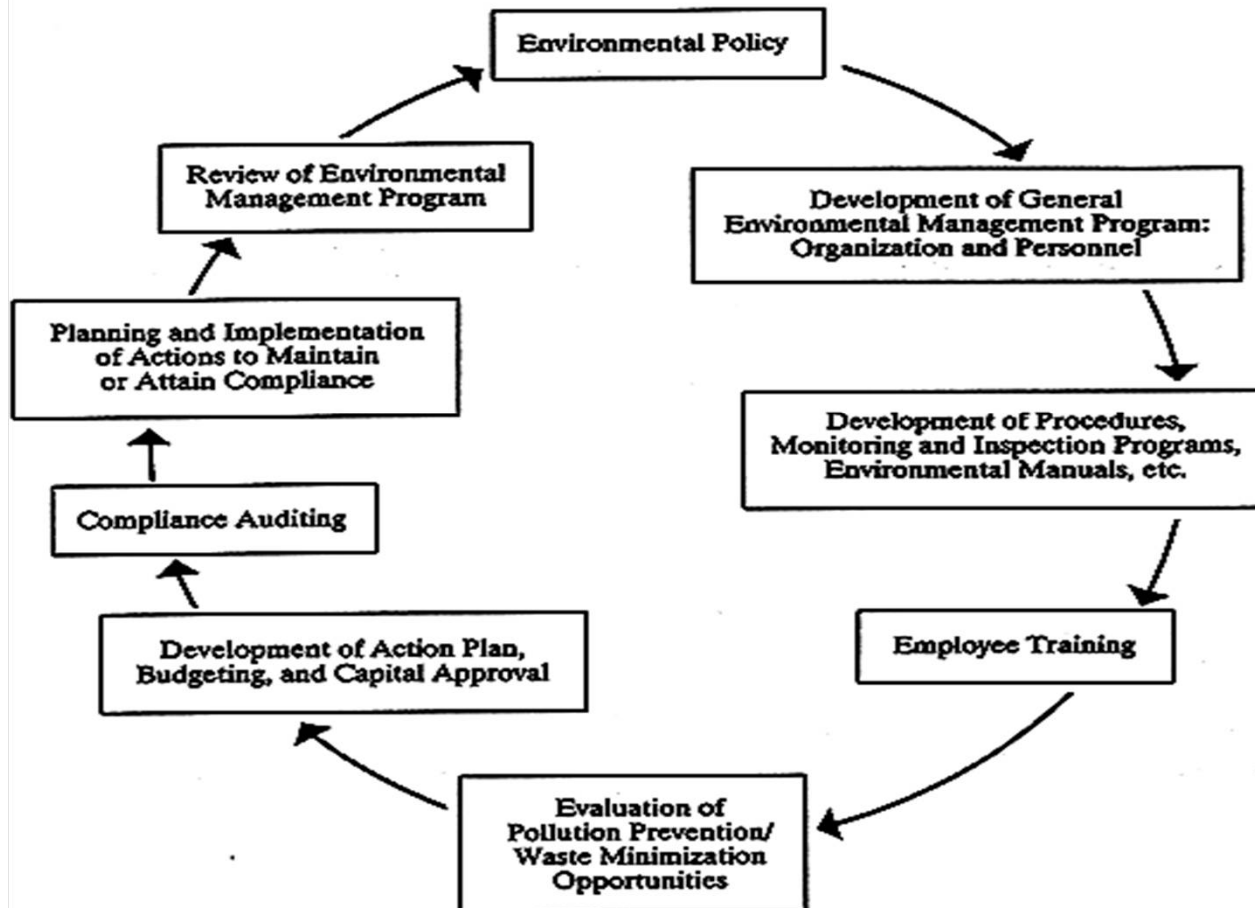
- **A systematic evaluation, review, or assessment of a facility or operation or an activity at a facility or operation to determine compliance with environmental laws or any permit issued under those laws**



# Why Environmental Auditing?

- **Environmental issues can be a significant source of liability**
- **A primary function of corporate leadership is management and avoidance of risk**
- **Important to understand the sources of liability and techniques or tools available to control or avoid it.**
- **Auditing is a key ingredient to informed decision making and risk avoidance and a key component of environmental management.**

# Environmental Management



# Audit Myths or Valid Concerns

- **What I don't know can't hurt me.**
- **If I discover something I will have to do something about it and that will cost big bucks.**
- **I will be worse off if I document it.**
- **If I am sued, the plaintiffs will have a field day with my audit report.**



# AUDITING- TECHNICAL SCOPING ISSUES



# Environmental Audit – Scope of Work

- **Define environmental media subject to audit**
  - Air
  - Water
  - Waste
- **Review of previous site assessments and environmental reports**
- **Review all existing environmental permits and operating conditions**



# Environmental Audit – Scope of Work

- **Review all records of monitoring and testing of equipment**
- **Access to the environmental manager or consultant familiar with compliance history, environmental policies, and documentation**
- **Allow time for detailed facility/site inspections**
- **Provide contracts or purchase records for regulated equipment, i.e. boilers, engines, combustion units**



# Environmental Audit – Scope of Work

- **Review of all previous notices of violations or citations identified by federal, state and local agencies**
- **Identify all facilities/properties owned or operated**
- **Review of maintenance records and service contracts, i.e. filter changes, disposal, chemical**
- **Operating records, i.e. hours operated, shifts**
- **Make everyone involved aware of the schedule**



# Governmental Incentives

- **1986 EPA Policy on Environmental Audits**
- **Department of Justice Position on Criminal Enforcement**
- **Draft Sentencing Guidelines**
- **EPA Memorandum on the Exercise of Investigative Discretion**
- **EPA Policy on Self-Policing-1995, 2000**
- **EPA New Owner Policy- 2008**
- **EPA Self-Policing Policy for Disclosures Involving Potential Criminal Violations**
- **State Audit Privilege Legislation**

# Texas Environmental, Health, and Safety Audit Privilege Act

- **Passed in 1995, amended 1997**
- **Provides incentives to conduct voluntary audits and implement corrective action**



# Incentives Established by Act

- **Limited Evidentiary Privilege**
- **Immunity from state administrative and civil penalties for violations disclosed as a result of the audit**
- **Structure for planning and implementing necessary corrective measures**

# Environmental Health and Safety Audit

- **Definition: a systematic voluntary evaluation, review, or assessment of compliance with environmental or health and safety laws or any permit issued under those laws conducted by an owner or operator, an employee or the owner or operator, or an independent contractor of:**
  - **a regulated facility or operation; or**
  - **an activity at a regulated facility or operation**

# Time Frame

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- **Once commenced the audit must be completed in a reasonable time not to exceed 6 months unless extension is granted**



# Notices Under the Act-Three Types

1. **Notice of Audit**-Notice given to TCEQ before commencing the audit.
  1. Required for immunity
  2. In writing and certified mail recommended
2. **Disclosure of Violation**
  1. made promptly upon discover of violation
  2. required for immunity
  3. certified mail required
3. **Request for Extension of Completion**

# Immunity Under the Act

- Disclosure must be voluntary and preceded by proper NOA
- PINNACLE-Voluntary disclosure
  - P: promptly
  - I: in writing by certified mail
  - N: not independently detected
  - N: noted and disclosed as a result of audit
  - A: appropriate efforts to correct
  - C: cooperates in investigation
  - L: lacks injury or imminent and substantial risk of injury
  - E: not required by Enforcement

# Limitations on Immunity

- **Does not affect the TCEQ's authority to seek injunctive relief**
- **Not available for violations which are intentionally and knowingly committed**
- **Not available if violation resulted in a substantial economic benefit which gives the violator a clear advantage over its business competitors**

## **Even if not immune the following factors will be considered in seeking penalties:**

- **Voluntary disclosure**
- **Efforts by the disclosing party to conduct an audit**
- **Remediation**
- **Cooperation**
- **Other relevant considerations**

# Environmental Protection Agency

- **Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations- 2000**
- **New Owner Policy- 2008**

# EPA's Incentives for Auditing

- **Elimination or substantial reduction of the “gravity” component of civil penalties**
- **Determination not to recommend criminal prosecution of the disclosing entity.**
- **Agency will not request copies of voluntary audit reports to trigger federal enforcement investigations.**

# Conditions of the EPA Audit Policy

- **Systematic discovery-audit or compliance management system**
- **Voluntary discovery**
- **Prompt Disclosure**
- **Discovery and disclosure independent of government or third-party plaintiff**
- **Correction and remediation**
- **Prevent recurrence-improve auditing and CMS**

# Voluntary Discovery

- **Violation must not have been discovered through a monitoring, sampling, or auditing procedure required by statute, regulation, permit, judicial or administrative order, or consent agreement**



# How Prompt is Prompt?

- **Disclosure in writing to EPA within 21 calendar days after discovery**
- **Trigger: When any officer, director, employee, or agent of the facility has an objectively reasonable basis for believing that a violation has, or may have occurred.**
- **Standard: What a prudent person having the same information would have believed**

# Correction and Remediation

- **Correct within 60 days or as expeditiously as possible**
- **If violation cannot be corrected in 60 days, the disclosing entity must notify the Agency in writing prior to the end of the 60 day period.**

# EPA's New Owner Policy

- **Addresses discoveries by a prospective purchaser made in the course of due diligence and disclosed following closing**
- **Provides enhanced incentives for a new owner conducting an audit following closing**
- **Eligibility and Conditions**

# New Owner Issue Under Texas Law

- **Texas Environmental, Health, and Safety Audit Privilege Act, while an excellent statute only applies to owners and operators**
- **The Act does not afford immunity to a prospective purchaser who discovers a violation during due diligence and corrects it following the closing**
- **Solution: Amend the Act to mirror EPA's New Owner Policy**

# Proposed Changes to Texas Law

- **Recognize due diligence conducted prior to an acquisition as an “audit”**
- **Eliminate the need for a Notice of Audit to be filed in advance if the audit is commenced as due diligence**
- **Allow a new owner to obtain immunity for violations discovered during due diligence and disclosed to the regulatory agency within 45 days of closing**
- **Allow a new owner to continue an audit commenced prior closing and obtain immunity for violations discovered during the on-going audit**

# Status of Legislative Initiative

- **SB 1300 and HB 3154 have been introduced**
- **Senate Committee hearing is schedule for next week and House Committee hearing may be held as early as next week**
- **Fingers Crossed/Knock on Wood–no opposition has yet surfaced**
- **Broad conceptual support from trade associations**
- **Both TCEQ and RRC have signed off on the concept**

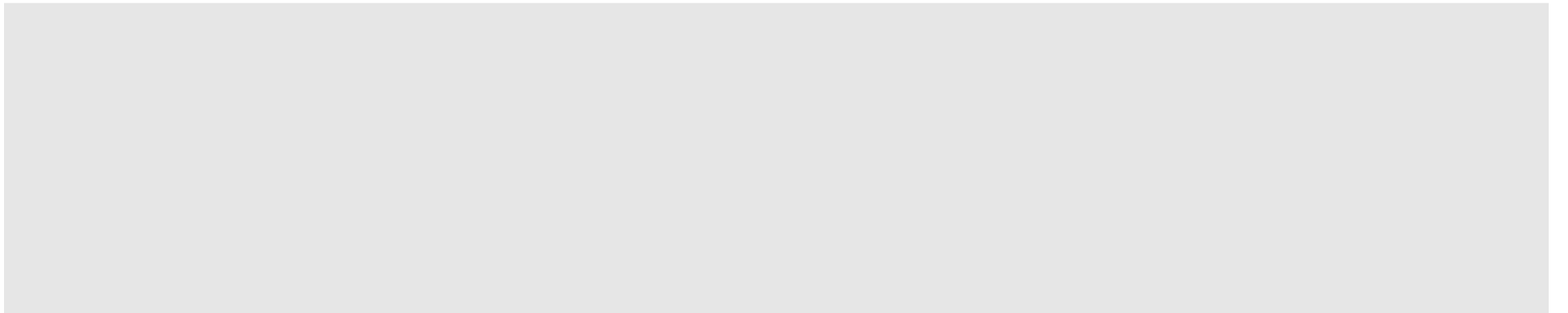
# How you can help:

- **Register your support in person or in writing**
  - Offer testimony at one of the upcoming hearings
  - Prepare and submit a letter supporting the legislation to the Committee Chair and to your elected representative
- **Help us fund our effort to change the law**
  - It takes time to push for change and we need some support to make this happen.
  - **Proposal**

# Questions?

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# All Appropriate Inquiry (“AAI”)

- **Specific outline for Phase I Environmental Site Assessment**
- **Origin – 1986 SARA amendments to CERCLA**
- **2002 Brownfield Amendments to CERCLA**
- **Standard of due diligence defined by EPA regulations 40 CFR Part 312**
- **ASTM Standard E1527-05 is consistent with EPA rule defining AAI**

# Permits – Basic Questions

- **Does the company have all required permits for the current operation and level of production?**
- **Is the company in compliance?**
- **Can amendments be obtained to authorize any intended changes? How quickly?**
- **Will proposed changes trigger more stringent requirements? Require emission credits?**

# Other Related Deal Issues

- **Nature of Deal**
- **Disclosures**
- **Representations and Warranties**
- **Materials and Thresholds**
- **Defects Process and Post Closing Actions**
- **Indemnity**

# Goal of Environmental Auditing

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- **Risk Avoidance or Control**
  - **Compliance**
  - **Damages**

# Benefits of Compliance

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- **Lessen Exposure to Civil and Criminal Sanctions**
- **Sound Sleep**
- **Impact on Productivity and Quality**

# Evidentiary Privilege

- **Applies to admissibility and discovery of audit reports in civil and administrative proceedings**
- **Does not apply to documents required to be developed or maintained independent of the audit process**
- **Does not apply in criminal proceedings**

# Purpose of EPA Audit Policy

- **Designed to enhance protection of human health and the environment by encouraging regulated entities to voluntarily discover, disclose, correct and prevent violations of Federal environmental laws.**



# Compliance Management System

- **Compliance policies, standards, and procedures that identify how employees and agents are to meet the requirements of laws, regulations, permits, etc.**
- **Assignment of overall responsibility for overseeing compliance**
- **Mechanisms for systematically assuring that compliance policies, standards, and procedures are carried out, including monitoring and auditing**
- **Efforts to communicate entity's standards and procedures to employees**
- **Appropriate incentives to managers and employees, including disciplinary mechanisms**
- **Procedures for prompt and appropriate correction of violations**

# Independent Discovery in the Multiple Facility Context

- **Discovery at one facility does not rule out application of audit policy at other facilities assuming the criteria are satisfied**
  - **Example**

# Which Violations are Excluded?

- **Violations that result in serious actual harm to the environment or which may have presented an imminent and substantial endangerment to public health or the environment. (yet to be invoked by the agency)**
- **Violation of terms of any order, consent agreement, or plea agreement.**

# Which Penalties

- **Gravity-based penalties only**
  - 100% if all 9 criteria are satisfied
  - 75% if criteria 2-9 are satisfied
- **No Relief from Economic Benefit Component**
- **No Recommendation for Criminal Prosecution**
  - If criteria 2-9 are satisfied

# Confidentiality in Environmental Auditing

- **Why is confidentiality important?**
  - **Confirmation process**
  - **Management involvement**
  - **Analysis of alternatives**
  - **Decisions**
  - **Liability**
  - **Employee relations**
  - **Shareholder relations**