
Transactional Environmental Due Diligence: What Diligence Is Due?

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Enacted in 1980, the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA or Superfund) discouraged parties from acquiring, financing, and developing contaminated properties (so-called brownfields), by dramatically changing the scope of liability and corresponding risks for parties dealing with such properties. In the 2002 Small Business Liability Relief and Brownfields Revitalization Act (Brownfields Amendments), Congress encouraged brownfields development by, among other things, providing relief to small businesses and funding for development of contaminated properties. More significantly, however, the Brownfields Amendments added defenses for prospective purchasers of brownfields and directed EPA to promulgate new standards for the type of environmental due diligence—or all appropriate inquiries (AAI)—required to obtain those types of defenses. On November 1, 2005, the agency promulgated its final AAI rule. Although the AAI rule likely will significantly affect how environmental due diligence is performed, the scope of AAI may not correspond to what is appropriate or prudent from a business perspective. This article briefly identifies potential environmental liabilities, provides background on CERCLA, analyzes the changes made by the Brownfields Amendments, discusses the scope and limitations of the Brownfields Amendments' AAI standard, and makes some practical recommendations regarding environmental due diligence.

To understand what diligence is due, it is important to understand the types of environmental liabilities that may arise under environmental statutes and the common law. Once those liabilities have been identified, a party can better understand the risks posed and how to manage them.

Environmental laws regulate human activities because of their actual or potential effect on the environment or on human health via the environment. Environmental liabilities arise not only under statutory law, but under common law as well. Environmental liabilities may include not only monetary costs and injunctive provisions, but also restrictions on land use.

Statutory liabilities include the costs of compliance and noncompliance. The costs to attain and maintain compliance with present and future regulatory requirements can be substantial. An entity may have to spend significant

amounts of money to purchase equipment or to change operations in order to comply with regulatory programs, or may have to spend a significant amount of time and money to obtain necessary permits. Failure to comply with regulatory requirements has its own set of costs. Most environmental statutes punish noncompliance with administrative and civil penalties and, for various levels of scienter, with criminal penalties, including imprisonment. In addition, noncompliance can result in injunctive relief to compel an entity to either come into compliance or cease operations until it achieves compliance.

CERCLA creates a different set of statutory liabilities. CERCLA liabilities include the costs of investigation and remediation of contaminated properties, as well as associated natural resource damages from the contamination. 42 U.S.C. § 9607(a)(2). These costs often run into the millions of dollars.

Sources of common law environmental liability include negligence, trespass, nuisance, and strict liability in tort, as well as contract claims brought by disaffected parties to transactions. Generally, tort litigants join parties based on their nexus to contaminated property or to polluting activities. Tort damages include damages for personal injury, damages to property, and diminution in property value. Although CERCLA does not establish private causes of action in tort, it does establish an exception to state statutes of limitations for cases involving hazardous substances. CERCLA trumps more conservative state statutes of limitations and establishes as the commencement date for the running of limitations the date the plaintiff knew or reasonably should have known that the hazardous substance involved, caused, or contributed to the personal injury or property damage. 42 U.S.C. § 9613(g)(1).

Environmental statutes also may result in restrictions on land use. For example, the National Flood Insurance Program effectively restricts development in the floodplain, and the federal Endangered Species Act restricts development in designated critical habitats or other areas in which endangered species may be present. The review required by these programs also may result in delay and regulatory concessions by agencies in exchange for required approvals.

Some pollution programs regulate land use directly. For example, Section 404 of the Clean Water Act operates as a de facto wetlands preservation program by restricting development in wetlands areas. Courts have construed the Clean Water Act to apply not only to the placement of dredged materials into bodies of water, but also to the use of tractors

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to clear bottomland hardwoods. On the local level, many cities have watershed protection ordinances that significantly affect development. Other state and local programs may restrict the withdrawal of groundwater and its availability for development purposes.

Superfund and other programs relating to on-site conditions may create de facto and, in some instances, de jure restrictions on land use (e.g., prohibitions on the use of ground water or continuing obligations to monitor its quality). Both federal and state Superfund programs also empower the government to impose a lien on remediated sites to secure payment of governmental costs in dealing with the site.

Some pollution programs restrict land use indirectly. For example, under the Clean Air Act, certain types of construction of new sources of air contaminants may be restricted based on the air quality of the region in which the property is located. Restrictions on existing sources of air contaminants also may affect the viability of a particular use. Similarly, under the Clean Water Act, discharges into watercourses may be restricted because of water quality limitations, which affect the uses available for property with wastewater discharge needs.

A critical factor in determining potential environmental liabilities, and thus the appropriate due diligence that should be conducted, is how the transaction is structured. In a stock acquisition, the company is essentially unchanged, so the liabilities are unchanged as well, and Superfund defenses are not available. Of course, the purchaser always retains the protection of the corporate shield, absent a merger or some grounds to pierce the corporate entity to reach the purchaser.

In an asset acquisition, the liabilities arise from existing conditions of the acquired assets, specifically, the risks of contamination being present and the current compliance status of the assets. Even in an asset acquisition, however, if there is the potential for successor liability (e.g., based on de facto merger, mere continuation, or continuing business enterprise), past as well as present liabilities, offsite as well as onsite liabilities, may be incurred and should be evaluated. Offsite liabilities include Superfund liabilities related to formerly owned and operated facilities and offsite disposal.

CERCLA and All Appropriate Inquiries

Before CERCLA, environmental statutes generally regulated conduct prescriptively, providing for penalties for violations. In CERCLA, Congress created a new paradigm, imposing liability based not on a violation of law but rather on a person's relationship to a site from which there has been a release or threat of release of a "hazardous substance." Although Superfund broadly defines the term "hazardous substance," it excludes from that definition petroleum and petroleum products and, thus, sites contaminated by gasoline and other petroleum products do not fall within its ambit. 42 U.S.C. § 9601(14).

Potentially responsible parties (PRPs) under CERCLA

include present owners and operators of a hazardous substance contaminated site, owners and operators of the site at the time hazardous substances were disposed, transporters who selected the site, and generators of waste who arranged for disposal of their wastes at the site. 42 U.S.C. § 9607(a). CERCLA liability is strict, generally joint and several, and unlimited. Unlike liabilities arising from violations, there is no limit on the monetary exposure, which also bears no relationship to the value of the subject property.

As originally enacted, CERCLA provided three defenses: (1) act of God; (2) act of war; or (3) act or omission of a third party. To claim one of these defenses, a PRP must show that the release or threat of release of hazardous substances and the resulting damages were caused solely by one or a combination of these three actors. 42 U.S.C. § 9607(b). Of these three original defenses, the most viable and frequently asserted is the third-party defense.

To claim the third-party defense, the defendant must show not only that the release or threat of release was caused solely by the act or omission of a third party, but also that: (1) the third party was not the defendant's employee or agent, or one whose act or omission occurred in connection with a contractual relationship, existing directly or indirectly, with the defendant; (2) the defendant exercised due care with respect to the hazardous substances; and (3) the defendant took precautions against the foreseeable acts or omissions of the third party and the consequences that could foreseeably result from the acts or omissions. Case law is split as to the contractual nexus necessary to preclude use of the third-party defenses. Some courts ignore the requirement that there be an act or omission "in connection with" a contractual relationship. For a further discussion of this issue, see Jeff Civins et al., *The Third Party and Transactional Related Defenses of CERCLA: An Overview*, ABA SEC. ENV'T, ENERGY, & RESOURCES ENVTL. LITIG. & TOXIC TORTS COMMITTEE NEWSL. at 3 (July 2005).

In 1986, Congress enacted the 1986 Superfund Amendments and Reauthorization Act (SARA), which modified the third-party defense with the innocent landowner (ILO) defense—the first defense to focus on parties to a real estate transaction. Under this defense, even if the proscribed contractual relationship were present, the PRP nonetheless could take advantage of the third-party defense if it could show that it satisfied the requirements for being an innocent purchaser: the PRP acquired the property after disposal of the hazardous substances and, at the time of acquisition, the PRP did not know and had no reason to know that any hazardous substances were disposed at the facility. 42 U.S.C. § 9607(b)(3) and 42 § 9601(35)(A)(i). SARA placed the defense in a carve-out from the definition of "contractual relationships," and defined contractual relationship to include land contracts, deeds, easements, leases, or other instruments transferring title or possession, without addressing the nexus requirement. 42 U.S.C. § 9601(35). Also included within the ILO defense were governmental entities that acquired property involuntarily

or through the exercise of eminent domain, and those who acquired property by inheritance.

To show at the time of the acquisition that a party “had no reason to know,” the party must show that it conducted “all appropriate inquiries . . . into the previous ownership and uses of the facility in accordance with generally accepted good commercial and customary standards and practices . . .” 42 U.S.C. § 9601(35)(B)(i)(I). Of the three ILOs, only innocent purchasers were required to show AAI; government entities and inheritors were not.

The Brownfields Amendments added to CERCLA two new defenses for prospective purchasers of brownfields, specifically, the transaction-related defenses of bona fide prospective purchaser (BFPP) and of contiguous landowner (CLO). These two defenses, together with the ILO defense, require that AAI be performed. They also generally require a showing of no affiliation with a liable party. Together, these two requirements comprise the threshold criteria. In addition to the threshold criteria, the three defenses also require satisfaction of certain continuing obligations. Collectively, the threshold criteria and continuing obligations are referred to as “the common elements.”

Following the enactment of SARA and the creation of the innocent purchaser defense, the generally accepted method of conducting AAI to fulfill the CERCLA requirement was the American Society for Testing and Materials (ASTM) Phase I standard—ASTM E1527, Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process. The Brownfields Amendments made clear that, until EPA promulgates rules for AAI, conducting an ASTM Phase I under standard E1527-97 would be sufficient. On May 9, 2003, EPA clarified that use of the newer ASTM standard, E1527-00, also would suffice.

The ASTM standard, E1527-00, sets out a list of components that must be incorporated into the Phase I assessment. These components included a records review, site reconnaissance, interviews with current owners and occupants and local government officials, and drafting a written report. The ASTM standard then set out detailed criteria on each of the components of the Phase I assessment, leaving little discretion for the person conducting the assessment to vary from the standard.

The Brownfields Amendments require that EPA define standards and practices for AAI, to include: (1) results of an inquiry by an environmental professional; (2) interviews with past and present owners, operators and occupants; (3) reviews of historical sources of information; (4) searches for recorded environmental cleanup liens; (5) reviews of governmental and other records; (6) visual inspection of the site and adjacent properties; (7) specialized knowledge or experience of the PRP claiming the defense and commonly known or reasonably ascertainable information about the site; (8) the relationship of the purchase price to the value of uncontaminated property; and (9) the degree of obviousness of the presence or likely presence of contamination and the ability to detect the contamination by an appropri-

ate investigation. In the August 26, 2004 *Federal Register*, EPA proposed a rule setting AAI standards and finalized that rule in the November 1, 2005 *Federal Register*. When it becomes effective November 1, 2006, parties must use the new AAI rule. In the meantime, parties may use either the ASTM E1527-00 standard or the new AAI rule. ASTM has issued a new standard, ASTM E1527-05, to conform to the new AAI rule, and EPA has indicated compliance with that new ASTM standard will satisfy AAI. The new AAI rule contains several significant changes from the old E1527-00 ASTM standard. These changes create new uncertainties and burdens that should be weighed in determining whether it makes business sense to implement an AAI protocol.

One of the more significant changes in AAI is a philosophical shift from prescriptive check-list style, to what has been characterized as a “performance-based” standard. The environmental professional conducting the assessment is afforded more flexibility to exercise judgment about what is necessary for the assessment. Further, the new standard requires the environmental professional to comment upon any data gaps identified during the assessment process and to determine the impact of the data gaps on the validity of the assessment. The lack of a prescribed checklist and the requirement for a data gap evaluation create uncertainty as to whether a particular assessment has met the performance-based standard.

Another important change is that the “environmental professional” who performs the investigation must meet minimum qualifications regarding education and experience, declaring in a report that he or she meets the definition of an environmental professional and has performed AAI in conformance with the rule. The rule does not require, but does recommend, that an environmental professional perform all onsite investigations. Requirements pertaining to the qualifications and role of the environmental professional likely will add cost to the investigation, although EPA suggests the costs are minimal. The rule also authorizes the purchaser or landowner to perform certain aspects of the investigation and, although not required, suggests that the purchaser provide the environmental professional the results of those investigations, such as searches for liens, assessment of specialized knowledge or experience of the landowner or purchaser, evaluation of commonly known or reasonably ascertainable information about the property, and evaluation of the relationship of the purchase price to fair market value of the property. The party’s failure to provide such information to the environmental professional may result in a data gap, upon which the environmental professional must comment.

The AAI rule also changes requirements for updating the investigation, mandating that investigations be performed within one year prior to the acquisition and that certain aspects of the investigation be updated within 180 days prior to acquisition, including, for example, lien and record searches, visual inspections, and environmental professional declarations. This “freshness” requirement may

affect the timing and logistics of transactions involving multiple properties and therefore the feasibility of conducting AAI.

The rule requires that interviews be conducted of not only the current owner and occupant, but also of additional individuals, including current and past facility managers, past owners, occupants, or operators, or employees of current and past occupants of the properties. This requirement not only creates additional uncertainties regarding whether AAI has been performed, but also raises issues with regard to the ability of the parties to a transaction to maintain confidentiality.

To clarify what is necessary for each of the three transaction-related defenses, EPA has published a Common Elements Guidance (Guidance). Memorandum from S. Bromm, Office of Site Remediation and Enforcement, U.S. Environmental Protection Agency, Interim Guidance Regarding Criteria Landowners Must Meet in Order to Qualify for Bona Fide Prospective Purchase, Contiguous Property Owner, or Innocent Landowner Limitations on CERCLA Liability (Mar. 6, 2003). As the Guidance explains, the common elements comprise both threshold criteria and continuing obligations for the three transaction-related defenses.

The Brownfield Amendments establish two threshold criteria. The first entails demonstrating no affiliation with a liable party and is applicable to only the BFPP and CLO defenses. (Statutory language, however, dictates that the ILO comes into play only if the act or omission giving rise to the contamination occurs in connection with a contractual relationship with the third party, rendering the third-party defense unavailable.) The second is performing AAI. The statute and the Guidance are clear that the inquiry must be conducted and completed before acquisition of the property. 42 U.S.C. § 9601(40)(B). If AAI uncovers contamination, then the ILO and CLO defenses will no longer be available because they require that the purchaser have no knowledge of the contamination, and the purchaser, therefore, is left with only the BFPP defense. Given the fact that actual knowledge does not preclude use of the BFPP, the ILO and CLO defenses should be superfluous for transactions occurring after January 11, 2002, the effective date of the BFPP.

In addition to the threshold criteria, the common elements include a set of continuing obligations that the purchaser must satisfy to continue to qualify for the defenses. The continuing obligations consist of five specific requirements: (1) compliance with land use restrictions and not impeding institutional controls; (2) implementing reasonable steps with respect to hazardous substances on property to stop and prevent releases and prevent or limit exposure; (3) providing cooperation, assistance, and access to persons authorized to conduct response actions; (4) compliance with information requests and subpoenas of EPA; and (5) providing legally required notices with respect to the discovery of hazardous substances.

Some of the elements of the continuing obligations are clear, such as complying with information requests and sub-

poenas, and there was a preexisting statutory obligation regarding this element. Others, however, in particular the requirement to take “reasonable steps with respect to hazardous substances,” leave wide discretion. Given the lack of case law regarding what is actually required under many of the continuing obligations, a landowner seeking to rely upon one of these three defenses is left with substantial uncertainty about what, if anything, must be done to comply. Moreover, “continuing obligations” and, in particular, the “reasonable steps” requirement, raise the possibility that compliance could be quite costly.

The Guidance has provided some indication of EPA’s position regarding the continuing obligations. In discussing a landowner’s obligation with respect to institutional controls, EPA would require a landowner seeking a defense not only to comply with land use restrictions and institutional controls in place at the time of purchase, but also to implement institutional controls in the future. EPA effectively also requires a landowner seeking the defense to look at all places where CERCLA-type land use restrictions might be documented, such as in risk assessments, remedy decision documents, remedy design documents, permits, orders or consent decrees, or in other documents developed in conjunction with the response action. EPA further states that a failure to grant an easement or a covenant necessary to implement a response action could in some cases constitute a failure to fulfill the continuing obligations.

The Guidance is particularly unhelpful on the issue of a landowner’s obligation to stop continuing releases, prevent threatened future releases, and prevent or limit exposure to hazardous substances. The Guidance indicates that EPA views the requirement as “consonant” with common law principles and CERCLA’s existing “due care” requirement. While acknowledging legislative history and statutory requirements indicating that absent “exceptional circumstances” a landowner would not be required to investigate or remediate contamination, EPA creates uncertainty when it states that Congress “did not intend to allow a landowner to ignore the potential dangers associated with hazardous substances on its property.” EPA goes on to state that because a BFPP buys with knowledge, as opposed to an innocent purchaser and CLO who purchase without knowledge, a BFPP may have a greater reasonable steps obligation.

The general tenor of EPA’s guidance is that any landowner, whether a BFPP, an ILO, or a CLO, must take “some positive or affirmative steps” in relation to contamination on its property, regardless of source or culpability. EPA’s examples of reasonable steps include repairing damaged containment systems, maintaining elements of an existing response action to prevent migration or repairing a damaged institutional control such as a cap over contaminated soils. When addressing the question of whether remediation of groundwater is a reasonable step, EPA fails to give an unequivocal answer. Similarly, when addressing the question of whether investigation of the extent of contamination is a reasonable step, EPA again equivocates.

Generally, EPA views some investigation but probably less than a “full environmental investigation” into the extent of contamination as required.

The uncertainty regarding what is necessary to satisfy AAI and the lack of clear guidance from EPA and the significant potential costs associated with continuing obligations should cause prospective purchasers of brownfields to question whether the effort to attempt to obtain any of the transaction-related defenses is worthwhile. This uncertainty and these potential costs undermine the objective of the Brownfields Amendments to encourage redevelopment of brownfield properties.

AAI's Shortcomings

Even if the common elements of the transaction-related defenses—including AAI and the continuing obligations—could be satisfied, the AAI protocol may not be worth implementing for two reasons: the defenses themselves provide limited protection and AAI has significant limitations.

Because all three defenses protect only against CERCLA liability, they have significant limitations in managing risk in environmental transactions. First, the defenses do not deal with one of the most prevalent types of contamination, petroleum contamination, because petroleum is excluded from the CERCLA definition of hazardous substances. As a result, a CERCLA defense is of no value to petroleum contamination. Second, the CERCLA defenses offer no protection against concerns that may arise under other environmental programs, including concerns relating to costs of compliance and noncompliance and land use restrictions (e.g., relating to wetlands and endangered species). Third, none of these defenses protect against liability under state statutory schemes, other federal statutes, or the common law.

The ASTM standards and the AAI standard also ignore critical items, which can result in failing to account for significant liabilities in transactions. Neither ASTM nor the AAI standards cover compliance, a prime concern in the acquisition of an ongoing business. In addition, neither ASTM nor AAI address liability associated with asbestos, lead-based paint, lead in drinking water, wetlands, endangered species, cultural resources, health and safety, indoor air quality, flooding, faulting, or stormwater runoff. It should be noted that although Superfund excludes petroleum products from the definition of hazardous substance, both the present and new ASTM standards, recognizing current practice, do require that petroleum products be investigated.

The shortcomings of the ASTM standards and the AAI standard are magnified when considered in the context of stock purchases and mergers-and-assets acquisitions that raise successor liability concerns. First, in a stock purchase or merger, the liabilities stay with the company and, as a result, none of the three Superfund defenses, which are tailored for asset purchases involving real property, are available. Yet, many still use the CERCLA standard as the template for due diligence. Second, neither standard addresses the issue of

what facilities should be investigated; in a stock purchase or merger, formerly owned or operated properties and offsite disposal locations must be evaluated in determining CERCLA liability.

Recommendations

Some courts have acknowledged, consistent with the express language of CERCLA § 107, that as long as there is no contractual nexus between the PRP and the act or omission giving rise to the contamination, the third-party defense remains available and the ILO defense, therefore, is not necessary. In that case, a prospective purchaser need not conduct AAI and satisfy many of the other common elements to use a CERCLA defense. Moreover, in determining whether to conduct AAI, a prerequisite to being able to take advantage of the three transaction-related CERCLA defenses, the prospective purchaser should understand that there are significant limitations on the scope of those defenses, not to mention the fact that each is an affirmative defense on which the defendant has the burden of proof. Additionally, the AAI protocol may be burdensome and impractical in the context of the particular transaction, and even if AAI is satisfied, the continuing obligations also required may be unduly burdensome. Finally, AAI does not address all the concerns a prudent party to a transaction will want to address. As a result, prospective purchasers may wish to design a more tailored approach to due diligence.

In the first instance, if AAI is practical, there is no downside to taking advantage of the possible defenses it may make available. However, performance of AAI may be impractical, because of the subjectivity of the analysis and constraints relating to confidentiality, timing, and costs. In some instances, for example, it may make more sense to go directly to sampling and the performance of a Phase 2, which can be designed with a preliminary investigation that falls short of AAI.

The major concerns with AAI relate to the items it does not address. Initially, a prudent purchaser will identify the properties upon which the investigation should focus. If the transaction involves a merger or the potential for successor liability, the investigation should address formerly owned and operated properties and offsite disposal locations, as well as presently owned properties.

In addition, the prudent purchaser should prepare a checklist of areas of inquiry excluded by the ASTM standards or AAI to determine which should be included. For example, if the acquisition involves an ongoing operation, a compliance assessment should be included. If the acquisition involves buildings, perhaps indoor air quality, including mold concerns, should be addressed, as well as the potential presence of asbestos, lead paint, and PCBs. If a development is proposed, endangered species, historic sites, wetlands, flooding and faulting should be considered. The menu of additional areas of inquiry will depend on the purchaser's proposed property use, objectives, and risk tolerance.

AAI does provide limited benefits that should be considered but not drive the environmental due diligence. The more tailored approach is the one that makes most sense. 