

“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 (the “Brownfields Amendments”), Congress encouraged brownfields development by, among other things, providing relief to small businesses and funding for 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, EPA promulgated its final AAI rule, which is codified at 40 CFR Part 312. Although the AAI rule has become a de facto standard for environmental due diligence, the scope of AAI may not correspond to what is appropriate or prudent from a business perspective. This article briefly identifies environmental concerns, 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.

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I. Environmental Liabilities of Concerns

To understand what diligence is due, it is important to understand the types of liabilities that arise under environmental statutes and common law. With an understanding of those liabilities, a party to a business transaction can better evaluate and manage the risks they pose.

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 under both statute and common law. They may include not only exposure to monetary costs and injunctive requirements, but also restrictions on land use.

Statutory liabilities include the costs of compliance and non-compliance. 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, as well as money, to obtain necessary permits. Failure to comply with regulatory requirements has its own set of costs. Most environmental statutes punish non-compliance with administrative and civil penalties, and, for various levels of scienter, with criminal penalties, including imprisonment. In addition, non-compliance can result in injunctive relief, to compel an entity to either come into compliance or cease operations until it achieves compliance.

CERCLA -- and analogous state laws -- create a different set of 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)(2002). 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, for example, involving contaminated real estate. Generally, tort litigants join parties based on their nexus to contaminated property or to polluting activities. Tort damages include damages for personal injury and damages to property and diminution in property value. Although CERCLA does not establish private causes of action, 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 federal Endangered Species Act restricts development in designated critical habitats or other areas in which endangered species may be present. The review required by this type of program also may result in delay and in the exacting of regulatory concessions by agencies in exchange for necessary approvals.

Some pollution programs regulate land use directly. For example, under the Safe Drinking Water Act, the Edwards Aquifer of Texas was established as a sole source aquifer, and the Texas Commission on Environmental Quality has imposed land use restrictions in counties located atop the aquifer recharge area. 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 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 developmental 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 may restrict land use indirectly. Under the Clean Air Act, for example, 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.

II. Differences between Stock and Assets Acquisitions

A critical factor in determining potential environmental liabilities, and thus the appropriate due diligence that a party should conduct, 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 has the protection of the corporate shield, absent a merger or some other grounds to pierce the corporate entity to reach it.

In an assets acquisition, the liabilities arise from existing conditions of the acquired assets, specifically, the risks of contamination being present and the current compliance status of that asset. Even in an assets 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, and offsite as well as onsite liabilities, may be incurred and should be evaluated. Differences in risks between assets and stock acquisition are summarized in the following table.

**Environmental Risks
Assets v. Stock Transactions**

	Assets Purchase	Stock Purchase
Onsite Conditions	X	X
Offsite Conditions		
Migration	X	X
Transport		X
Formerly Owned		X
Land Use	X	X
Non-Compliance		
Past		X
Present	X	X

III. CERCLA “All Appropriate Inquiry (“AAI”)

A. Context

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. Liability for those petroleum related products generally arises under other statutes, *e.g.*, section 311 of the Clean Water Act and the Oil Pollution Act.

Those liable under CERCLA, so-called potentially responsible parties or PRPs, 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. § 9601(14) (2002). 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 property being bought or sold.

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 successfully assert 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 types of acts. 42 U.S.C. § 9607(b) (2002). Of these three original defenses, the most viable and frequently asserted has been the third party defense.

To successfully assert 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 have ignored the requirement that there be an act or omission “in connection with” a contractual relationship. *See* Civins, Mendoza, and Fernandez, “The Third Party and Transaction-Related Defenses of CERCLA: An Overview,” ABA SEC. ENV’T, ENERGY & RESOURCE 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 § 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 that 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* (“AAI”) 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). Of the three ILOs, only innocent purchasers were required to show AAI; government entities and inheritors were not.

As noted, the Brownfields Amendments added to CERCLA 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 innocent purchaser prong of the ILO defense, each require that AAI be performed. They also generally require a showing of no affiliation with a liable party. Together these two requirements comprise the so-called 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.”

The relationship among the various defenses and the elements of each are very confusing. The attached chart is helpful in clarifying both relationships and elements.

B. Elements

Following the enactment of SARA and the creation of the ILO defense, the generally accepted method of conducting AAI to fulfill the CERCLA requirement was ASTM E-1527, Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process.

The ASTM standards set out a list of components that had to be incorporated into the Phase I assessment. These components included a records review, a site reconnaissance, interviews with current owners and occupants and local government officials, and the drafting of a written report. The ASTM standards then set out detailed criteria for 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 required that EPA define standards and practices for AAI and spelled out the elements those standards and practices were to incorporate. Those elements included: (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 appropriate investigation.²

As noted, EPA's November 1, 2005 AAI rule, which became effective November 1, 2006, is codified in 40 CFR Part 312. In its rulemaking, EPA indicated compliance with ASTM's standard, ASTM E1527-05, would satisfy AAI. The AAI rule contained several significant changes from the former ASTM standard.

C. Changes and Concerns

One of the more significant changes in AAI was a philosophical shift from a prescriptive, check list style, to what has been characterized as a "performance-based" standard. The environmental professional conducting the assessment is given more leeway in exercising judgment about what is necessary for the assessment. Further, the standard requires that the environmental professional 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 was that the "environmental professional," who performs the investigation, must meet minimum qualifications regarding education and experience and must declare in the report that he or she meets the definition of environmental professional and has performed AAI in accordance with the rule. The rule does not require, but does recommend that

² CERCLA Section 1010(35)(B)(ii) and (iii).

an environmental professional perform all on-site investigations. Requirements pertaining to the qualifications and role of the environmental professional have added cost to the investigation.

The rule authorizes the purchaser or landowner to perform certain aspects of the investigation, including 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. Although not required, the rule suggests that the purchaser provide the environmental professional the results of those investigations. 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 rule mandates 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, and 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.

IV. Common Elements

To clarify what is necessary for each of their three transaction-related defenses, EPA published a Common Elements Guidance (the "Guidance"). Memorandum from S. Bromm, Office of Site Remediation and Enforcement, United States 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" (March 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 established two threshold criteria. The first criterion entails demonstrating no affiliation with a liable party and is applicable to only the BFPP and CLO defenses. (By definition the innocent purchaser defense 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 criterion is performing AAI. The statute and the Guidance are clear that the inquiry must be conducted and completed before acquisition of the property. 42 USC §9601(40)(B). If AAI uncovers contamination, then the Innocent Purchaser 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 actual knowledge does

not preclude use of the BFPP, the Innocent Purchaser and CLO defenses should be superfluous for all transactions occurring after January 11, 2002, the effective date of the BFPP. In addition, in most cases involving contiguous landowners, the third party defense should be available, making the CLO defense unnecessary.

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) complying 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) complying 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 subpoenas, because there was a pre-existing statutory obligation regarding this element. But others, 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, he must do 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 as to what EPA believes is required 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 when it comes to the steps a landowner must take 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 intent 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 innocent purchaser, or a CLO, must take "some positive or affirmative steps" in relation to contamination on its property. 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 into the extent of contamination as required but probably less than a "full environmental investigation."

The uncertainty regarding what is necessary to satisfy AAI and the lack of clear guidance from EPA and 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.

V. Shortcomings of AAI

Even if the common elements of the transaction-related defenses -- including AAI and the continuing obligations -- could be satisfied and the concerns discussed above addressed, the AAI protocol may not be worth implementing for two reasons: (1) the defenses themselves provide limited protection; and (2) AAI has significant limitations.

A. Limitations of the CERCLA Defenses

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 and liabilities that may arise under other environmental programs, including issues 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.

Fourth, these defenses, unlike prospective purchaser agreements, a tool EPA utilized that allowed prospective purchasers to nail down their obligations prior to acquisition, provide no certainty prior to a transaction that a prospective purchaser will be protected and what that purchaser must do to qualify for the protection. They are all defenses upon which the purchaser must carry the burden of proof, to be asserted at trial after the purchaser is sued.

B. Limitations of AAI

The ASTM and AAI standards miss critical items, any of which can result in unaccounted-for, significant liabilities in transactions. Neither ASTM nor the AAI standard covers compliance, a prime concern in the acquisition of an on-going business. While the ASTM standard includes petroleum in the scope of its assessment, AAI generally would exclude it. In addition, neither ASTM nor AAI pick up asbestos, lead based paint, lead in drinking water, wetlands, endangered species, cultural resources, health and safety, indoor air quality, flooding, faulting, or stormwater runoff.

The shortcomings of the ASTM and AAI standards are magnified when considered in the context of stock purchases and mergers, which 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. Second, neither standard addresses the issue of what facilities should be investigated, for example, in a stock purchase or merger, formerly owned or operated properties and off site disposal locations should be evaluated in determining CERCLA liability.

VI. Recommendations – A More Tailored Approach

As discussed, some courts have acknowledged, consistent with the express language of CERCLA section 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 avail itself of a CERCLA defense. Moreover, in determining whether to conduct AAI, which is 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 they are affirmative defenses 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.

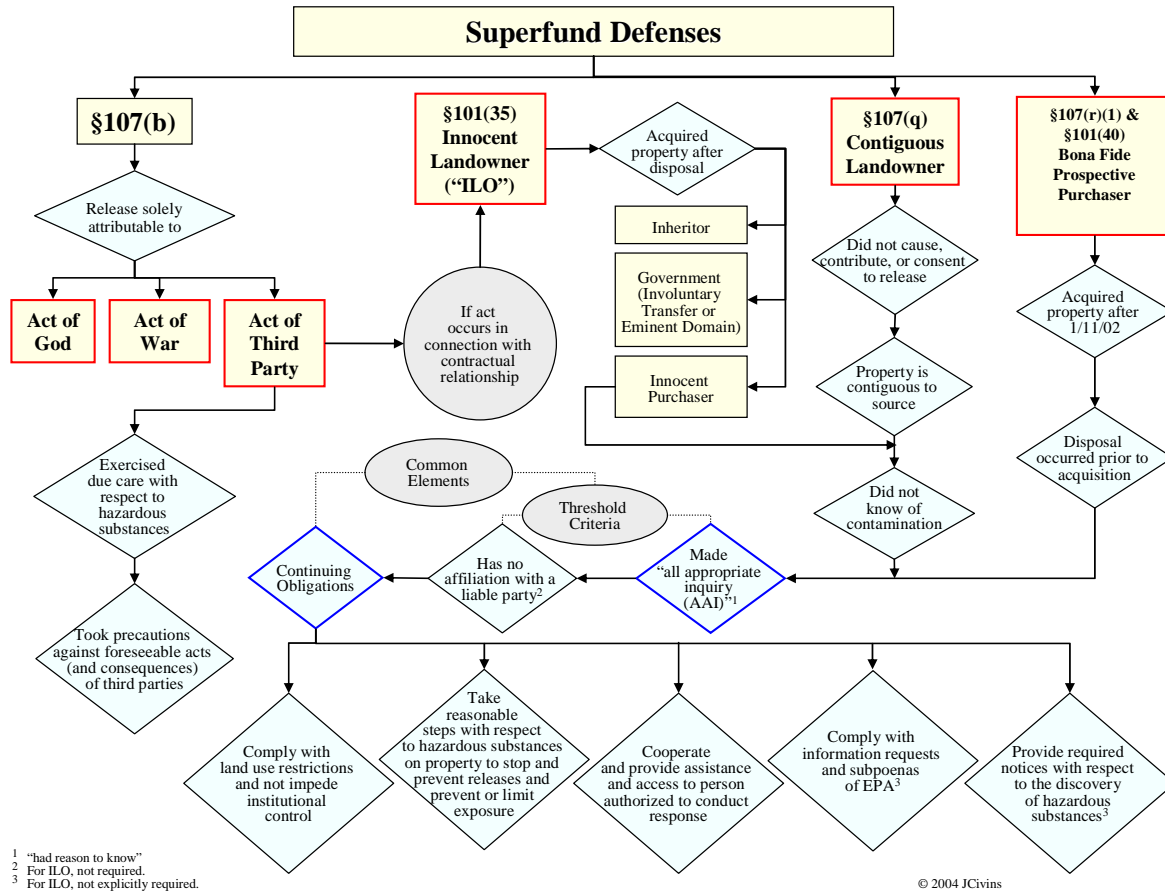
In the first instance, all other things being equal, if AAI is practical, there is no downside to taking advantage of the possible defenses it may afford. All other things, however, likely will not be equal: performance of AAI may be impractical, because of the subjectivity of the analysis and constraints 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 will want to prepare a checklist of areas of inquiry excluded by the ASTM or AAI standards, 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 perhaps should be considered. The menu of additional areas of inquiry will depend on the purchaser's proposed property use, objectives, and risk tolerance.

AAI provides benefits, but they are limited. AAI should be taken into account, but should not drive the environmental due diligence. The more tailored approach is the one that makes most sense.



A version of this chart originally appeared in the July 2005 issue of the newsletter of the Environmental Litigation and Toxic Tort Committee, Section of Environment, Energy and Resources (SEER), American Bar Association (ABA), in an article entitled, "The Third Party and Transaction-Related Defenses," by J. Civins, M. Mendoza, and C. Fernandez, and was reproduced in Amending CERCLA: the Post-SARA Amendments to the Comprehensive Environmental Response, Compensation and Liability Act, by Michael B. Gerrard and Joel Gross, SEER, ABA (2006)