

What Constitutes Environmental Due Diligence?

Different Levels of Due Diligence for Different Types of Acquisitions: Green Fields, Brownfields, Operating Terminals and Leases

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What does environmental due diligence include? That depends on the nature of the acquisition. In the US, the standards for conducting environmental due diligence are set forth by the Environmental Protection Agency in Title 40 CFR Part 312: Innocent Landowners, Standard for Conducting All Appropriate Inquiry, which references the American Society for Testing and Materials (ASTM) E 1527-05 *Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process*. But, in both cases, the standards leave it up to the environmental professional to determine the level of assessment that is warranted for an acquisition and consult the client on all the options.

The environmental due diligence process can present significant opportunities. If managed skillfully during a transaction, you can not only save money *and* avoid environmental liabilities; you can also enough about a property or operation that you can structure your acquisition and future development and use of the property or facility based on that information.

The information obtained during the environmental due diligence process can be a tremendous bargaining tool. You can negotiate on the price and use legal counsel to incorporate protection (indemnifications, warranties, representations, hold backs, or escrows) in the acquisition agreement to cover identified environmental liabilities and costs.

But, you need to identify the environmental liabilities early on during the acquisition process. Discovering environmental liabilities or contamination after an acquisition means “*you own it*”, along with all the costs and potential delays and loss of operating revenue.

GREEN FIELD PROPERTIES

For the *acquisition of a “green field” property* (property that has never been developed), a Phase I Environmental Site Assessment (ESA) is an appropriate level of due diligence. Even though you are purchasing a green field property, which has the lowest level of risk for environmental problems, the Phase I ESA provides you with a very inexpensive “insurance policy”. A Phase I ESA can be extremely informative and includes:

- ▶ Researching the historical use of the property including historical aerial photographs, topographic maps, fire insurance maps, city directories, and other local resources.
- ▶ Researching the regulated facilities located on or surrounding the property including Superfund sites; leaking underground storage tank sites; dry cleaning facilities; landfills; hazardous waste disposal sites; oil and gas exploration and production sites; spill sites; corrective action sites; etc.
- ▶ Interviewing persons familiar with the property such as the current owner and operator, past owners and operators, and surrounding property owners;

- ▶ Conducting a site reconnaissance to observe the potential presence of a **Recognized Environmental Condition (REC)**, defined as “the presence or likely presence of hazardous substances or petroleum products on a Property under conditions that indicate an existing release, a past release, or an observable or obvious threat of a release of hazardous substances or petroleum products into structures on the Property or into the ground, groundwater, or surface water of the *Property*, excluding de minimis conditions that generally do not present a threat to human health or the environment and that generally would not be the subject of an enforcement action if brought to the attention of appropriate governmental agencies”; and
- ▶ Preparing a report to document the findings of the Phase I ESA.

A Phase I ESA typically costs \$3,000 - \$6,000, depending on the size, location, and use of the property, and can be completed within two to three weeks. If no recognized environmental condition, or potential contamination, is identified, then no further investigation is warranted and the Phase I ESA will satisfy the due diligence requirements and any lending institution requirements.

BROWNFIELD PROPERTY

For the **acquisition of a “Brownfield” property** (property that has been used for commercial or industrial activity), a Phase I ESA may only be the beginning of the due diligence process. Conducting a Phase I ESA of a Brownfield property is likely to uncover RECs. In which case, a Phase II ESA is necessary to fulfill the environmental due diligence requirements. A Phase II ESA typically includes surface and/or subsurface investigations to collect samples to test for the presence of contamination. Examples of Phase II ESA activities include:

- ▶ Installing soil borings and collecting soil samples in areas of observable stains or in areas near current or previous underground or above ground storage tanks, pipe chases, sumps, or any suspected waste disposal area either on the Property or adjacent properties;
- ▶ Installing groundwater monitoring wells and collecting groundwater samples in areas of suspected subsurface releases including those items mentioned above;
- ▶ Sampling sediments and/or surface water for the presence of contamination;
- ▶ Conducting an asbestos survey for building materials and insulation materials;
- ▶ Sampling abandoned wastes in containers, tanks, and process equipment; and
- ▶ Conducting additional agency file research to obtain and review site-specific files, such as adjacent regulated sites, to determine the possible presence of contamination from off-site.

Depending on the nature and extent of the potential contamination, a Phase II ESA can cost \$10,000 to \$100,000 or more and can take two to three months to complete. One of the critical elements of the Phase II ESA is to determine where to sample and what constituents to include in the sampling and analytical protocol. This requires properly assessing the historical use and development of the property during the Phase I ESA.

Even when completed, the Phase II ESA may only identify the presence of contamination, but may not define the full extent of contamination. For example, the Phase II ESA may document

groundwater contamination, but the extent or the source of the contamination may not be defined and the contamination may be deeper and/or may be more extensive, with potential releases to off-site properties.

At this stage, the environmental due diligence process can be viewed as a major impediment to closing a deal to purchase additional property. However, if you end up saving \$250,000 to \$750,000 in a reduced price for your acquisition, the environmental due diligence can be viewed as a strategic element of an acquisition. For example, if you discover groundwater contamination that extends off-site, you can incorporate legal provisions into the acquisitions agreement to avoid liable to off-site property owners. The Phase I & II ESA provides you the information to protect your terminal from all the numerous and various environmental liabilities so that you are not *betting the farm*.

OPERATING TERMINALS

The *acquisition of an operating terminal* entails additional and more complicated environmental due diligence. A Phase I & II ESA is only part of the equation: the other part of the equation includes an assessment of the environmental compliance, permitting and operational conditions of the facility. Environmental compliance includes a whole host of regulatory programs (air, water, waste, spill prevention, etc.), each with their own long list of regulatory requirements, too many to even mention here. And, conducting a detailed environmental compliance audit can be a time-consuming and expensive endeavor. However, some level of environmental compliance auditing needs to be performed and should be focused on the high level issues. Often, a “level of materiality”, or dollar value is used to focus the due diligence audit on the issues that will cost more to address and include the following:

- ▶ **Permitting** – Does the facility have the air permits to store your products? Does the facility have or need wastewater or storm water permits? Are the current operations being conducted in compliance with the facility permits? If you change ownership, do any “grandfathered” permit conditions change?
- ▶ **Violations, fines and complaints** – Are there any outstanding violations or pending fines or penalties? Does the facility have a history of violations or penalties? What is the facility’s relationship with regulatory agencies and the local community?
- ▶ **Spill control and management** – What are the current and historical methods of controlling spills not only from storage tanks and pipelines, but from tank truck and rail car loading and unloading operations? How many and what kind of spills have occurred and are there records to document satisfactory remediation? Do the secondary containment systems meet the regulatory requirements?
- ▶ **Management of tank bottoms and rinse water** – What are the current and historical methods of managing tank bottoms, and methods of managing rinse water generated between storing different products? Do the facility records verify the management methods?
- ▶ **Waste disposal** – What are the current and historical methods of waste disposal? What off-site facilities have been used for waste disposal? Is the facility or any of the off-site waste disposal companies listed as a “potentially responsible party” (PRP) in any Superfund Sites? What is the risk of incurring long-term liabilities for past waste disposal practices?

- ▶ ***Maintenance records related to spills and releases*** – By reviewing maintenance records, are there any areas of needed improvement(s) that could require significant capital expenditures to prevent future spills and releases or to meet regulatory requirements?
- ▶ ***Historical operations*** – Have there been any historical operations that have been discontinued (ie: tank truck and rail car washout areas, product blending areas, underground storage tanks or sumps, biodegradation or land farming of tank bottoms, etc.)?
- ▶ ***Visual inspections*** – Is there any evidence of spills and releases (particularly in loading and unloading areas, around pumps, pipelines, sumps, drip pans, etc.)? Are there any newly surfaced areas that could be camouflaging historical spills?

A special concern when conducting due diligence of an operating facility is the confidentiality issue. Most of the time, the operating personnel are not aware of the pending sale of the facility. Therefore, the environmental assessment can be conducted as an audit with the stated purpose of the audit being an insurance requirement, a bank requirement, or just a routine environmental audit.

Based on the findings of the environmental assessment, it may be determined that the environmental risks are manageable and provisions can be incorporated into the acquisition agreement to account for any environmental costs or potential environmental remediation liabilities. For example, the seller might retain liability for some issues and the buyer might take over responsibilities for other issues.

Frequently, it is not possible to fully determine the presence or delineate the extent of contamination during the due diligence process due to time constraints. However, a good environmental consultant can assist in estimating the remediation costs, which can be used by the legal counsel in the acquisition negotiations. For issues where the environmental liability cannot be determined, such as off-site groundwater contamination liabilities, the buyer will certainly want legal protections incorporated into the acquisition agreement, and may consider purchasing environmental liability insurance. But, it is imperative that the environmental due diligence process be started early on in order to obtain all the necessary information to be of any value.

LEASING PROPERTY

If you are not acquiring property, but leasing property from a Port Authority or other entity, there is still an environmental due diligence process that should be followed. In this case, the due diligence should include comprehensive research on the historical use of the property, interviews with persons knowledgeable about the property, and a site reconnaissance to identify obvious environmental conditions. The focus of the assessment is to identify the pre-existing conditions that could cost you money to clean up at the end of the lease, or worse yet, could result in a regulatory agency forcing you to conduct a cleanup during your lease.

Based on this due diligence information, you can then design a study to establish an “***environmental baseline***”, or the current condition on the property. For example, there may be potential soil and/or groundwater contamination from previous on-site operations. You can perform strategic surface and/or subsurface sampling investigations to document the nature and extent of the contamination. Depending on the nature of the contamination, you may want the

Port Authority or other owner to remediate the contamination prior to your lease or during a specified time-frame. As an alternative, you may take on the remediation in order to expedite the process, but may use this to negotiate a reduced lease price.

It is almost certain that any lease agreement will include termination provisions that will require you to remove all wastes and remediate any environmental contamination. Without an environmental baseline, you don't know what pre-existing contamination may be present and you don't know what you may be required to remediate at the end of the lease, which is a significant financial risk. However, if you have an environmental baseline, your legal counsel can negotiate the lease to provide protection from the environmental liabilities for pre-existing conditions.

REFINANCING PROPERTY

If you are refinancing an existing operation with a lending institution, most lenders will require some level of environmental due diligence, typically a Phase I ESA. This can be a little tricky for an operating terminal facility because often there is evidence of potential spills and/or releases. Therefore, the scope of work for the Phase I ESA must be carefully designed to focus on the big picture. The risk in doing a Phase I ESA that is not properly designed is that the lender can require additional investigations and/or remediation prior to refinancing your operations. No one wants to conduct investigations and potentially open up a can of worms that may require reporting and remediation. Before starting a Phase I ESA, it is wise to conduct an internal inspection of the facility to identify and resolve any issues that might be discovered during the due diligence process.

In addition, some lenders will want to use their own environmental consultants, or a consultant that is approved by their institution. Often times, your consultant can become an approved consultant in a short time-frame, assuming that they are qualified and have the necessary state licenses. It is always preferred to use your own consultant who understands your objectives and goals.

ENVIRONMENTAL DUE DILIGENCE IS INFORMATIVE AND FUN!

It never ceases to amaze me what we find during the environmental due diligence process. It is very informative and fun to get all the historical information and piece it all together. The property may have been used previously as a trolley car maintenance facility, or a gas station, or a wood treating facility, or an oil production site, or a landfill or a stock yard with a meat processing plant, or . . . The possibilities are endless! Determining how the property has been used and assessing the potential for contamination is the first step of the environmental due diligence process. Then it is up to your legal counsel to use this information in the acquisition negotiations and incorporate legal protections into the transaction agreement.

Even when there is not time to conduct a Phase II ESA to investigate suspected contamination associated with a railcar loading area, an attorney can assist you to include provisions in the acquisition such that the seller will retain responsibility for any contamination associated with that area. So, don't worry about finding things in during a Phase I ESA; you aren't necessarily required to perform a Phase II ESA. You can still move forward on your acquisition with good legal advice.

So *start the environmental due diligence as early as practical*. Don't let someone else's environmental liabilities become yours or, at least, know what you are signing up for in terms of environmental liabilities. Furthermore, most environmental liabilities are manageable as there are a several environmental regulatory programs in place that can facilitate the acquisition of contaminated property and regulations that can be utilized to manage environmental remediation cost-effectively and in a timely manner.

“Terminals continuing to expand without conducting the appropriate level of environmental due diligence may learn the hard way. Don't let your terminal become the next case study!”

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