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Environmental Due Diligence For M&As During The Pandemic

By **Matthew Dobbins** (April 24, 2020, 5:34 PM EDT)

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The COVID-19 pandemic has severely disrupted global and domestic M&A activity. Still, parties continue to identify strategic transactions — and one open question is how to properly due diligence environmental liabilities while living in a COVID-19 world.

Most of the U.S. is subject to stay-at-home or shelter-in-place orders, and likely will remain so at least through the end of May 2020. Traditional environmental due diligence tools are limited — and if a transaction involves a distressed entity, post-closing protections like indemnities and escrow funds may not be viable solutions.

Insurance products may provide some relief but can also have significant transaction costs. Deals can still get done, but timing can be affected as a result of new and evolving requirements from either insurers or third-party financiers. Buyers and sellers need to take these constraints and their impact on environmental liability protections into account when determining timelines for signing and closing deals.

Classic Environmental Due Diligence

Environmental liabilities frequently represent deal-killers, either because of direct financial risk (e.g., remedial or tort liabilities) or reputational risks. The first line of defense against these liabilities has traditionally been the Phase 1 environmental site assessment.

Phase 1 assessments are typically performed by a professional engineer or geologist (or someone under such a person's direct supervision), pursuant to the ASTM International E1527-13 standard, which relies upon a visual inspection of commercial properties for the purposes of identifying potential contamination liability. Phase 1 assessments are also often performed so that purchasers have the ability to avail themselves of one of the already limited number of defenses to liability available under the Comprehensive Environmental Response, Compensation, and Liability Act, or CERCLA, also known as the Superfund law.[1]

CERCLA is a strict liability environmental statute, imposing liabilities on current owners and operators of properties where releases of hazardous substances have occurred without regard to fault. Performance of a Phase 1 assessment is key to satisfying CERCLA's "all appropriate inquiries," or AAI, requirement for parties seeking liability protection under the bona fide prospective purchaser, innocent landowner, or

contiguous property owner defenses.[2]

Promulgated by the U.S. Environmental Protection Agency following the 2002 Small Business Liability Relief and Brownfields Revitalization Act, the AAI rule imposes a number of requirements on the scope of a Phase 1 assessment, including interviews of past and present owners and operators, environmental lien searches, searches of government records, and a visual site inspection.[3]

Separate from CERCLA liability protections with respect to Phase 1 assessments are third-party considerations. Representation and warranty insurers, or RWIs, typically require Phase 1 assessments before agreeing to provide coverage for environmental issues.

Many lenders also require a Phase 1 assessment before they will agree to finance a transaction. The inability to perform a Phase 1 assessment could result in these third parties demanding more onerous environmental due diligence, exclusions in policy coverage, or demanding burdensome corporate parent guarantees and indemnities against potential environmental liabilities as a precondition to financing.

Options For Environmental Due Diligence in a Time of Restricted Movement

To date, the EPA has not issued guidance on how to complete the AAI requirement in the context of restrictions related to COVID-19. At least 41 states are currently subject to stay-at-home or shelter-in-place orders, exempting only essential businesses from operating restrictions.

Many of these states link their definition of essential businesses to guidance from the U.S. Cybersecurity and Infrastructure Security Agency, or CISA.[4] As a threshold matter, buyers will need to determine how a target's operations have been impacted by these state restrictions, whether or not any facilities have been idled, and what steps were taken to minimize environmental risks, such as securing above-ground storage tanks or chemical totes used during operations.

While the CISA guidance lists a broad array of industries, environmental consulting and engineering firms are not explicitly identified. Environmental remediation and monitoring workers are identified, but with the caveat that this is limited to "critical need technicians."

Arguably, remediation services are distinct from Phase 1 assessments. And although many of the broad categories include "workers who support" certain essential industries, such as the chemical, energy and critical manufacturing (e.g., aluminum and steel, semiconductors, industrial minerals) sectors, no further guidance is provided to give assurance that environmental consultants performing a Phase 1 assessment would fall into the category of workers exempt from shelter-in-place orders.

Still, CISA's guidance explicitly states that it is not meant to be an exhaustive list of what should be considered essential, and environmental consulting firms support many of these industries in a variety of ways, such as permitting and compliance. In addition, many states are still allowing home inspections in support of real estate transactions — so logically, environmental inspections to facilitate transactions involving commercial real estate should also be allowed in such states.

Nevertheless, some ambiguity exists. Moreover, lack of explicit guidance poses particular issues for transactions involving facilities in multiple states, because even if a certain state largely follows CISA's guidance, there may be differences at the state or local government level that could impact a consultant's ability to perform a site visit.

Against this backdrop, there are several different paths that may be available to navigate environmental due diligence.

Attempting to Wait Out the Restrictions

The simplest and likely most effect solution, if available, is to wait until the end of any applicable shelter-in-place orders. Deals that are not on compressed closing timelines may be able to avoid any impacts from COVID-19 responses that restrict the performance of Phase 1 assessments.

The EPA's regulations allow for Phase 1 assessments to be conducted within 180 days of closing,[5] so signing can still occur without an assessment. Many are hopeful that shelter-in-place and similar orders will be lifted sometime between May and June, which would provide several weeks for deals with July 2020 closing targets to complete environmental due diligence.

However, parties still need to proactively manage their environmental due diligence and ensure that consultants have been engaged early, so that the non-site-inspection components of the AAI rule can be satisfied — and so that Phase 1 assessments may be scheduled and completed without delay once business and travel restrictions have been lifted.

Building A Case That a Good Faith Effort Was Made to Comply With AAI

The EPA noted in the preamble to the final AAI rule that "visual on-site inspection of a property during the conduct of all appropriate inquiries may be the most important aspect of the inquiries."[6] Nevertheless, the final rule still contained a limited exception to the requirement for visual inspections when such inspections cannot be performed because of physical limitations or other inability to obtain physical access to a property.[7]

Qualifying for the exemption requires that a good faith effort be made to obtain access, including (1) visual inspection of the property via another method; (2) documentation of efforts to obtain access, and an explanation of why the efforts were unsuccessful; and (3) documentation of other sources consulted to determine if any releases have occurred that could affect the environmental condition of the property.[8]

The report by the environmental professional must comment upon the significance of the failure to visually inspect the property with respect to the professional's ability to identify any releases or potential releases.

Although no reference is made in the rule text or the final AAI rule preamble to global pandemics qualifying as a reason why an environmental professional cannot access a site, the preamble for the final rule does identify extreme weather events as one potential basis.[9] If an act of God, such as an extreme weather event, serves as a basis for excusing the visual inspection requirement, then a similar case can be made for a viral outbreak that triggers widespread government travel and work restrictions.

However, the mere existence of these factors alone will not be sufficient to excuse strict compliance with AAI requirements. Buyers should consider the following additional measures if they are unable to perform a site inspection as a result of COVID-19 restrictions but still wish to establish potential CERCLA defenses:

- Contacting state and local officials and attempt to gain permission for an environmental professional to perform a site visit and document these efforts;

- If permission cannot be obtained, utilizing technology such as drones to inspect a property as thoroughly as possible;

- Assuming the seller is an essential business and continues to operate, asking the seller to have an employee use real-time video technology so that an environmental professional may direct the seller's employee to perform a virtual inspection; and

- Performing a visual site inspection as soon as practicable after any restrictions related to COVID-19 have been lifted.

To date, no court appears to have had to address the issue of whether or not the lack of a visual site inspection is critical to meeting the AAI requirement. Any party whose environmental diligence does not include a Phase 1 assessment, and who subsequently seeks to establish a defense to CERCLA liability, would likely face an uphill battle.

Actions taken or not taken today will be viewed in hindsight after liabilities arise, and there may be a tendency for courts to conclude that alternative approaches (e.g., delaying closing) should have been more strongly considered. Buyers will need to analyze their due diligence efforts against the requirements in the final AAI rule, and the limited guidance provided by EPA in the final rule preamble, to build the strongest case possible that the AAI standard was met.

Negotiating Acceptable Environmental Due Diligence Alternatives With RWIs and Banks

Lack of a Phase 1 assessment can still create deal risks with respect to third-party insurers and lenders, even if the buyer is not concerned with completing the AAI requirement. These third parties tend to rely on the buyer's environmental due diligence, and do not undertake an independent environmental due diligence review.

A third party such as an RWI or a bank may be willing to accept a Phase 1 assessment that attempts to satisfy the visual inspection requirement through the use of drones or real-time video inspections as outlined above, even if a court might find such efforts insufficient to establish a defense to CERCLA liability.

Concerns from these parties about the AAI requirement should not have a significant bearing on an RWI's or lender's decision-making (even though they still may). For example, RWIs are generally not entitled to rely on a buyer's Phase 1 assessment, nor is there plausible scenario where an RWI could be deemed an owner or operator under CERCLA, thus removing the value of satisfying the AAI rule for an RWI.

However, the absence of a Phase 1 assessment increases an RWI's underwriting risk. And while lenders frequently request reliance letters from a buyer's environmental consultants, CERCLA contains several protections for lenders so long as they do not participate in the management of the facility where a release subject to CERCLA has occurred.[10]

Similar statutory protections are available to lenders, even if the lender were to temporarily take possession of a facility in the context of foreclosure, so long as the lender limits their possession to a few

discrete actions and seeks to sell or re-lease the property "at the earliest practicable, commercially reasonable time using commercially reasonable means."[11] Nevertheless, a lender's risk tolerance may preclude them from accepting anything other than a traditional Phase 1 assessment.

The different environmental risks that RWIs and lenders face does not mean that no or limited environmental due diligence should be sufficient, but rather that buyers may be able to provide comfort that a visual site inspection is not critical to protecting the interests of these parties. This will require as fulsome an environmental due diligence process as ever, such as a "desktop review" of environmental databases like Environmental Data Resources; state permitting and enforcement resources; records from the seller; Google Earth and historical aerial photographs; and telephone interviews with the seller.

Sellers who typically rely on making records available only at their facilities should consider how to manage potential document-sharing burdens. Buyers should proactively engage RWIs and lenders at the earliest possible point to discuss an acceptable scope of environmental due diligence.

Alternative Post-Closing Environmental Protections

Even if a buyer is not seeking representations and warranty insurance or third-party financing, constraints on environmental due diligence imposed as a result of COVID-19 can still impact environmental risk management. Distressed sellers may not represent a viable source for post-closing indemnification, but there are other methods for mitigating post-closing environmental liability if a buyer was not able to conduct their standard environmental due diligence.

Traditionally, post-closing protections involve indemnification with a survival period of a year or more, coupled with an escrow account of similar duration to support the indemnification obligations. In a distressed transaction scenario, a seller will not want to lock up funds for long periods of time if it needs cash or is winding up a business.

Still, depending on a seller's financial situation, there are a variety of ways that parties could arrange to hedge against potential environmental liabilities. First, buyers should have their legal and technical environmental due diligence team develop a range of lowest-case, most-reasonable-case, and worst-case cost scenarios based on the nature of a target's operations, the age of its facilities, its compliance history, and other factors that a buyer can identify without the need for a site visit.

Then, depending on the seller's situation, the parties could seek to negotiate some form of a short-term set aside and post-closing payment of funds from buyer to seller to cover potential environmental costs. Given the cost of setting up an escrow account, such an arrangement could take the form of a short-term (one to two months) earn-out agreement, where additional funds are released following the removal of COVID-19 related restrictions and completion of satisfactory site visits.

Depending on the costs and underwriter demands, an agreement to use a portion of the purchase price to fund the procurement of an environmental insurance policy may represent another method to safeguard against environmental risks.

Deals continue to occur, even during times of economic disruption, and environmental due diligence needs to adapt to fit client needs. Buyers may need to reassess their risk tolerance with respect to environmental liabilities when potentially faced with constrained due diligence. Some of the suggestions above may be impractical given the balance of leverage between the parties or because of other limitations, but buyers should explore all options.

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[1] 42 U.S.C. § 9601 et seq.

[2] 40 C.F.R. § 312.1.

[3] Id. §§ 312.23-27.

[4] Guidance on the Essential Critical Infrastructure Workforce, Cybersecurity and Infrastructure Security Agency, https://www.cisa.gov/publication/guidance-essential-critical-infrastructure-workforce (last accessed April 8, 2020).

[5] 40 C.F.R. § 312.20(b).

[6] 70 Fed. Reg. 66,070, 66,095 (Nov. 1, 2005).

[7] 40 C.F.R. § 312.27(c).

[8] Id. § 312.27(c)(1)-(3).

[9] 70 Fed. Reg at 66,095.

[10] 42 U.S.C. § 9601(20).

[11] 42 U.S.C. § 9601(20)(E)(ii).