EH&S Advisor

Doing the Deal

Part 2: Property Assessments

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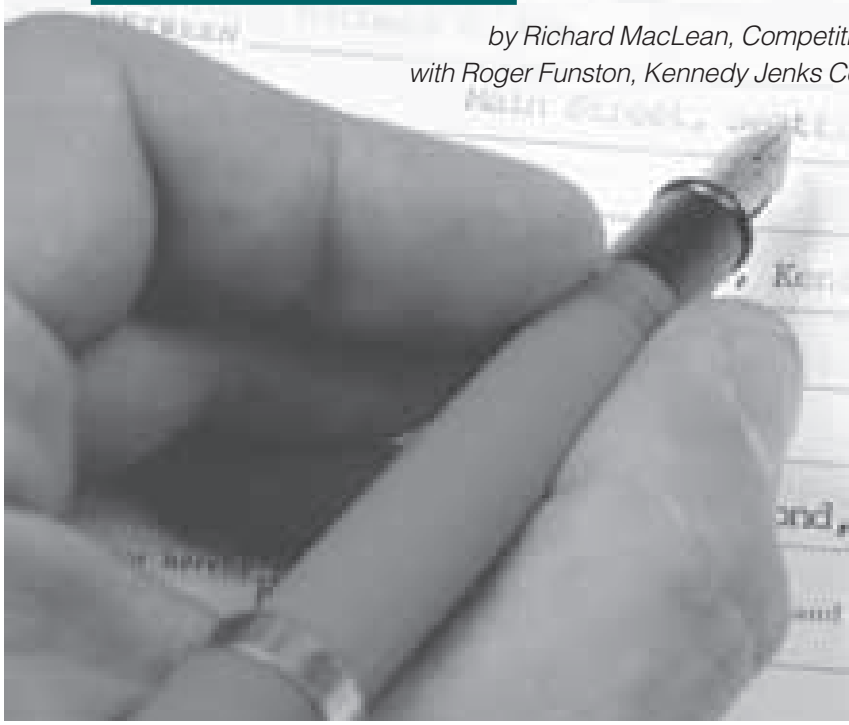

Providing support for major business transactions is arguably the most important strategic responsibility of an EH&S manager. The potential cost savings (if done correctly) or liabilities (if done poorly) can be enormous. A company may bet its future success on a single business acquisition or merger. Even purchases or divestments of plant and equipment can have a profound effect on a company.

This is the second of a three-part series on business transactions. Last month, we explored the politics of "doing the deal" and some best management practices of leading companies. This month, we examine specific approaches to business risk assessments based on input from experienced consultants. Next month, we will analyze the value of environmental management systems assessments in mergers and acquisitions.

It's hard to imagine today, but contaminated property issues were rarely a business concern just 20 years ago. All that changed in 1979 when the House Commerce Committee's Subcommittee on Oversight and Investigation sent out a questionnaire on waste disposal to the chemical industry. The Eckhart Survey, named after the Subcommittee chairman, was the first systematic survey of hazardous waste disposal at a national level. The survey shook up the industry because (1) Congress was directly involved, and (2) it was the first time that management saw in aggregate how much waste had been disposed and, thus, the magnitude of their potential liability. The results helped motivate Congress to pass Superfund legislation (Comprehensive Environmental Response, Compensation, and Liability Act, or CERCLA) in 1980.

Superfund had immediate and far-reaching consequences. For some corporate executives, this was their first exposure to significant environmental issues. I can vividly recall explaining the legal concepts of strict liability (i.e., without regard to fault) and joint and several responsibility (i.e., collectively and individually responsible, without regard to relative contribution) to business managers. "But it is so *unfair*!" they complained.

STANDARD PRACTICE EVOLVES

Standard Practice for Environmental Assessments: Phase I Environmental Site Assessment Process (ASTM E-1527) was developed in 1997 to provide a uniform framework for conducting site inspections.[1] The original driving force behind inspections was the need for buyers to shield themselves from significant liability. Proper due diligence (i.e., using the ASTM protocol) would qualify a buyer under CERCLA's innocent landowner defense.

In addition to industry, banking institutions quickly moved to require environmental assessments before issuing commercial loans. Financial institutions are so tuned-in to property contamination issues today that they no longer automatically foreclose on property, for fear of inadvertently taking on environmental liability as an owner. The concern for contamination has more recently expanded to include residential property, with many banks and state laws requiring asbestos, underground storage tank, lead paint, and radon inspections before closing. Even Joe and Jane Homeowner are now familiar with these environmental requirements.

A revised ASTM standard is currently being balloted, which includes the following qualifier in the purpose section: "A complete evaluation of business environmental risk associated with a parcel of commercial real estate may necessitate investigation beyond that identified in this practice."

This statement recognizes that property transactions today can be very complex deals with many potential objectives beyond just minimizing CERCLA-type liabilities. Indeed, the reasons for proactively managing site contamination have grown significantly over the past 20 years (see sidebar, "Top 10 Reasons

to Proactively Manage Site Contamination"). We will examine two of the more common property acquisitions. Our purpose here is only to provide an overview—just enough to caution the reader to seek expert advice even on seemingly mundane, property transactions.

ONGOING INDUSTRIAL OPERATIONS

The level of effort and timing for conducting environmental due diligence of a pending acquisition depends on the structure of the deal and how risk is allocated between the seller and the buyer. Although there is a multitude of ways to structure a deal, they typically fall into three categories: post-closure agreement, seller indemnification, and as-is sale.

Post-Closure Agreement

A post-closure agreement means that the buyer conducts due diligence after property transfer, with the seller agreeing to pay for buyer-identified environmental problems above an established threshold. This structure was more common in the late 1980s and early 1990s, but is rarely seen today. It allows for a quick property transfer by postponing the due diligence step until later. The seller bears the risk of an uncertain final sale price for the property. The buyer bears the risk that the seller will not honor claims, making it necessary to pursue litigation.

Seller Indemnification

A seller indemnification agreement means that the seller agrees to indemnify the buyer for all environmental impairments that existed *before* the date of transfer and the buyer agrees to indemnify the seller for problems discovered *after* the date of transfer. This structure requires that both parties agree to a "baseline" environmental condition at the time of property transfer. The thoroughness of the seller's environmental disclosure documents will greatly influence the scope of the buyer's due diligence efforts.

As with post-closure deal structures, indemnity agreements generally require the seller to show the maximum amount of potential liabilities in their financial statements as contingent liabilities. This disclosure may impair the seller's ability to access capital. A promise to pay future costs is only as good as the financial condition of the seller at the time a claim is made. Also, the seller may deny a claim, forcing litigation.

As-is Sale

In an as-is sale agreement, the buyer conducts environmental due diligence prior to property transfer. The seller will generally consider adjustments to the purchase price for buyer-identified environmental impairments, with the likelihood of adjustments being made dependent on the level of "proof" required by the seller. In this type of deal, the seller will generally not consider any post-closing adjustments to the purchase price.

This category is becoming more commonplace. It shifts much of the risk to the buyer and often delays the timing of property transfer, since the buyer must conduct all of their due diligence before closing. If adequate time is available, sellers prefer this type of deal because they do not have to account for contingent liabilities on their balance sheets.

Top 10 Reasons to Proactively Manage Site Contamination

1. Identify and correct environmental problems to reduce the potential for civil and criminal liability, litigation, and fines.
2. Acquire information for financial and strategic planning and prioritize needs in relation to resources.
3. Maximize property value for potential divestitures.
4. Provide accurate cost projections to meet financial accounting standards and disclosure regulations.
5. Identify strategic issues that may preclude facility expansions or diminish the perceived value of businesses.
6. Enhance the company's reputation in the community and with regulators.
7. Increase shareholder value.
8. Gain critical data that will greatly improve the company's negotiating position on acquisition and divestiture business transactions.
9. Allocate responsibility for liability issues between the company and the owners of divested company property.
10. Avoid liability problems with toll production, joint ventures, and lease arrangements.

REDEVELOPMENT PROJECTS

The key questions for Brownfield developers are: "What will it cost to get the property to a clean, developable condition?" and "Can I still make my required rate of return on my investment if I incur these extra costs?" Brownfield development is as much an economic issue as an environmental issue. As such, the primary technical objective is to develop a cost estimate based on environmental conditions, the most likely remediation goals required by regulatory agencies, and public perception/liability concerns.

A phased effort is the most cost-effective approach. The first phase is a fast-track, limited scope Phase I Environmental Site Assessment to identify potential liabilities and sample

locations for the Phase II Environmental Site Assessment. If findings from the Phase I Assessment suggest that significant environmental impairments exist, the developer can back out of the deal with minimum investment. If the deal looks promising, Phase II can commence, again in limited stages.

It is critical to solicit early involvement from local regulatory agencies and planning and building departments. Very sensitive redevelopment projects (e.g., redevelopment of schools) may need elected officials and community leaders to serve as prime promoters. Some of the choicest real estate in inner cites were once factory locations, but budgets can be rapidly eaten up defining risk nuisances for sites the local community is dead set against.

Brownfield development may involve land use planning issues, geotechnical requirements, soils placement/disposal requirements, health risk evaluations, disclosure requirements for future homebuyers, environmental justice concerns, and the risk of future toxic tort lawsuits. These considerations may influence a developer to remediate a property to a "cleaner" level than required by regulatory agencies.

No matter how carefully the site assessment was conducted, there is always the possibility that the actual cost of site remediation will be substantially higher than estimated. Environmental cap liability insurance may be available to pay for cost overruns on environmental remediation projects. In making a decision on whether or not to purchase environmental cap insurance, a developer must balance the cost of premiums and the policy deductible amount against the risk of cost overruns.

CONCLUSION

Buyers and sellers of industrial property need to consider a wide variety of economic, regulatory/political, and risk/liability factors to make informed business decisions. A well-thought-out strategy implemented through an environmental business risk assessment allows both parties to make informed decisions. The business objectives, public and regulatory acceptance, and the level of risk each is willing to assume will determine the final outcomes. What was a non-issue 20 years ago is today a complex undertaking, often requiring specialized legal and engineering support.

REFERENCES

1. *Annual Book of ASTM Standards*; ASTM S110498; American Society for Testing and Materials: Philadelphia, PA, 1998; Vol. 11.04.

PLEASE ASK, PLEASE TELL

Is there an EH&S topic you would like to address in *EH&S Advisor*? Do you have information to share with your colleagues, and are you interested in coauthoring a column on the subject? *EM* is very interested in your ideas. Please contact Richard MacLean by phone: (480) 922-1620 or e-mail: *maclean@competitive-e.com*.

EH&S ADVISOR CHECKLIST

Risk Assessments of Industrial Properties

1. **Business Objectives of Buyer**—Designing a business environmental risk assessment that meets the buyer's needs requires an open dialog between consultant and buyer. Considerations include
   - level of environmental impairments considered significant;
   - complexity and timing of the deal;
   - can risk be managed through insurance?; and
   - underlying motivations of both the buyer and seller.

2. **Structure of Property Sale**—The manner in which risk is allocated between the buyer and seller can dramatically affect timing:
   - Will the seller allow post-closure adjustments based on environmental discoveries after the date of sale, or must all price adjustments occur prior to sale?
   - Will the seller offer indemnification to the buyer for pre-existing conditions?
   - What is the likelihood that the seller will have the financial strength to honor buyer claims?
   - What regulatory commitments and obligations will the buyer inherit upon assumption of operations?
   - What will it cost to get the property to a "clean" condition?
   - Can the target required rate of return on the project be achieved?

3. **Site Remediation Strategy for Redevelopment Projects**—Use a fast-track Phase I and II Site Assessment to confirm the general nature of environmental impairments. Using an iterative process to refine estimates, you should focus on three areas:
   - *Technical/economic*—Level of investigation effort required to identify problems and develop a remediation cost estimate.
   - *Regulatory*—Most likely remediation goals required by oversight agency for intended future land use; importance of early and frequent contact with oversight agency to avoid project delays and unexpected costs.
   - *Political/legal*—Delays associated with potential land use conflicts, public perception, toxic tort suits, etc., and the impact on project timing and cost.

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