ENVIRONMENTAL DUE DILIGENCE: THE DANGERS THAT LURK BENEATH

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In any business transaction, it is imperative to identify at an early stage whether any known or potential environmental problems exist. This can never be determined with certainty, but it is important for parties to a proposed transaction and their lawyers to turn their minds to the issue. Once known or potential environmental problems are identified, the risks associated with them must be addressed or allocated. That is the essential environmental due diligence in a corporate transaction.

Environmental issues are often contentious issues and are frequently of such a magnitude as to be considered "deal breakers". As a result, they are commonly left to be resolved at the last minute. This is not always sound strategy. Recognizing the potential problems as early as possible will have a definite impact on the appropriate negotiation strategy for a given transaction. If parties invest considerable amounts of time and resources in working toward the completion of a transaction, they are less likely to want to walk away from it at the end because of environmental risks. If they become aware of environmental issues at an early stage, they can plan appropriately for the best time to negotiate the allocation of those risks in light of their bargaining position.

Legislative and Regulatory Framework

The legislative and regulatory landscape has a significant impact on the way environmental risks are allocated, and it is important for all involved to have a basic understanding of this framework. In Ontario and at the Federal level, there are numerous statutes

which govern the environment, most of which have detailed regulations which accompany them. Although traditionally the Federal government's role was limited, it has recently been expanding. Federal legislation in the environmental areas generally deals with cross-border impacts, Federal Government undertakings, dangerous substances and railways, fisheries and other subject matters assigned to the Federal Government in the Canadian Constitution. Through such recent statutes as the *Canadian Environmental Protection Act*, the Federal Government has become an important player in environmental regulation. Its role can be expected to continue to grow in the future.

A thorough description of environmental law is obviously beyond the appropriate scope of this paper. However, there are certain broad themes that inform environmental law. Among other things, these include:

1. Prohibitions against contaminating the environment or exceeding maximum allowable levels of contamination;
2. Requirements to report spills;
3. Requirements for approval of control measures;
4. Permit, registration and record keeping requirements;
5. Decommissioning of facilities no longer in use.

Failing to comply with any prohibition or requirement can have serious consequences, leaving the offender subject to regulatory orders, prosecution (as strict liability offences) and civil liability.

Most environmental law is by statute and regulation. The passage of this legislation is a quite recent development in our law. For example, Ontario's *Environmental Protect Act* was not passed until 1971. This recent explosion of law-making has in many instances upset traditional

legal principles. In the case of the sale of contaminated property, for example, the traditional legal principle of "buyer beware" has to a very large extent been supplanted by statute, at least in respect of the discharge of contaminants. Ontario's *Environmental Protection Act* contains numerous provisions which provide that regulators can issue orders to former owners of property, and civil remedy provisions give a right of action against former owners for certain types of contamination. This has to be taken into account in any business transaction with environmental impacts, because regulators are not necessarily bound by the allocation of risks between and among the parties. From a social perspective, this may make some sense, but it complicates the business allocation of risks.

<u>Sources and Reliability of Information Concerning Environmental Conditions</u>

From the perspective of a party or solicitor in a proposed transaction, one of the biggest practical problems is the gathering and reliability of information. There are numerous potential sources of information with regard to the environmental condition of a site, including company records, the parties themselves, employees, consultants, regulators and third parties.

The solicitors for the parties will likely have some role in the collection of information, but all concerned will be better served if it is made clear that assessing environmental risks is not within a lawyer's competence. Typically, a consultant (either in-house or outside) will be used to gather and assess environmental information. Parties should be careful to require that outside consultants carry professional liability insurance and it is generally preferable that the consultants be retained directly by the party involved and not as an agent of the solicitors.

The sources of information available are diverse and far-ranging, making it difficult to ever be satisfied that all pertinent information has been collected. Furthermore, even if all

available information is checked, there is always a strong possibility that additional undiscovered contamination exists. In framing agreements and conducting due diligence, parties and their solicitors should be careful to take this into account.

i. Disclosure by the Parties

A vendor of a contaminated property will usually, but not always, be the best source of information concerning it. As a result, it is important for the purchaser of real estate or a business to build in some obligation on the vendor's part to disclose environmental concerns. Typically, agreements will be structured to contain representations and warranties about the environmental status of a site, which will often include a representation and warranty that the site is clean except for certain disclosed concerns. These are usually accompanied by an indemnity provision which often, but not always, mirrors the representations and warranties.

It should not be forgotten that existence of contamination and its extent is not always a matter of objective fact. Rather, it is a matter of interpretation of data and the assessment of the degree of risk. Furthermore, the data interpreted is always limited and imperfect.

The manner in which potential issues are disclosed will affect the parties' treatment of those issues. The more risks that are disclosed, the more likely they are to have an impact on the price to be paid and whether the transaction proceeds. The wording of disclosure in such schedules can be extremely important, and decisions with respect to what is material enough to be disclosed are often difficult.

From the point of view of the vendor (and depending on the wording of the agreement), if the objective is to minimize future liability for misrepresentations and breaches of warranty, the

disclosure of environmental concerns ought to be fulsome and inclusive, erring on the side of disclosure.

On the other hand, a purchaser and its solicitors should keep in mind that their own due diligence investigations may in some circumstances prevent a successful claim for misrepresentation or breach of warranty. This is particularly the case if the language of the representation and warranty clauses are based upon "knowledge" (e.g., using a phrase such as "to the knowledge of …"). Generally speaking, however, it is usually better to know what risks are faced and to deal with them in advance of the transaction if possible.

ii. Employees' Information

In addition to all of the records of the company and the information of those responsible for environmental issues, other employees may have knowledge pertinent to the environmental record of the business and condition and history of the site. It would be helpful to address the status of such information, particularly where employees of the vendor go to work for the purchaser following the sale. How this information is treated can have an important impact, especially if representations are knowledge-based. From a purchaser's perspective, care should be taken to make clear whether or not the information of such employees belongs to the purchaser. Interviewing a vendor's employees (and past employees) is rarely done, but is something which could be considered if practical. These issues are further complicated in considering sites with a lengthy history, since standards of industrial practice have changed tremendously over the years, and since there is often a lack of reliable information as to what took place previously on a site.

iii. Company Records

Where the records of a business enterprise with environmental issues are sold, the status of this information should also be clarified. Acquiring ownership of such records may imply that the company acquires knowledge of the content of the records, and it would be preferable to establish firmly the legal status of the information.

iv. Consultants

Consultants typically discover information by reviewing the history of a property and by identifying potential issues such as the existence of storage tanks, waste streams from the business and the typical contaminants associated with a particular industrial process. Where potential problems are identified, the drilling of boreholes and taking of samples to measure the level of contamination is a frequent method of gathering information from which to extrapolate conclusions.

v. Other Sources of Information

It is often important and worthwhile to obtain information available in government ministry files with regard to a particular property, which is often available under Freedom of Information legislation. Information about a site can also be obtained from aerial photographs.

vi. Shared Information

Where parties co-operate in dealing with environmental matters, the parties and their solicitors must consider the mechanics and impact of sharing information. Typically, vendors will provide purchasers with copies of any consultants' reports they have. In these

circumstances, the sharing of such reports may well vitiate any privilege that attaches. Nevertheless, purchasers will want to have access to any and all environmental reports, including those that may be privileged, and it may well be inappropriate to fail to disclose the reports. If the reports are to be disclosed, it is recommended that the parties agree that any privilege is to be waived only as between the parties, and both parties should agree not to make disclosure to third parties (except of course as required by law). Even this may not be sufficient to preserve privilege, but it is worth trying.

Remediation Cost Estimates

Where there is a known problem, consultants will often be asked to estimate the costs of the cleanup. On the one hand, parties have little choice but to rely upon the best estimates of the consultants they retain. At the same time, however, such estimates are notoriously inaccurate.

The nature of contamination is such that it is often hidden, and contaminants do not always lend themselves to easy and accurate identification. For one thing, they move in the ground and groundwater, either laterally or vertically, depending on the nature of the subsurface soil, groundwater conditions, solubility and other chemical and physical characteristics of the contaminants and the site. Some contaminants will have a tendency to gather in particular locations. Thus, even the most diligent of consultants may miss or mis-estimate the extent of contamination. Even where the existence and precise extent of contamination is known, the cleanup costs can often turn out to be much more expensive than originally estimated. As a result, recourse against the consultant is not always available or appropriate.

One possible method for avoiding the potential for cost overruns is to provide for environmental insurance. Such insurance is often expensive, and the process to obtain it can be

difficult, but it is a potential solution that should be considered. It is especially attractive where public companies are concerned, in that some auditors will take the view that liabilities covered by insurance need not be disclosed in financial statements.

Transfer of Environmental Approvals on Closing

In a regulatory environment, there are numerous environmental permits, registrations and certificates of approval that are required, and detailed record-keeping requirements. In the sale of a business, these will need to be transferred. Agreements will often require the vendor to list all permits, registrations and certificates of approval that are required to be transferred. These transfers will usually have to be arranged prior to closing, and adequate time should be left to ensure that it can be done. In many cases this is relatively simple, but the policies of the regulators involved may change from time to time with regard to the transferability of such documentation, so these issues should be addressed well in advance of closing.

With regard to the adequacy of record-keeping, purchasers should at least ensure that such records as may exist are turned over. Where records do not exist, they cannot be created, but it may be important for a purchaser to know of the absence of records.

Post Closing Escrow Funds

Parties will often wish to quickly wind up the implications of a transaction, so that they can get on with their respective businesses. While sensible from a business point of view, this often complicates issues from an environmental perspective. Frequently, parties will establish an escrow fund to pay for any remediation work, for a limited period of time. This is typically used where to clean up a problem is thought to be a relatively simple procedure but will take several

months, and the parties wish to close their transaction in the meantime. Often, the vendor will agree to carry out certain remediation work and will establish a fund to satisfy the purchaser that there will be money available to pay for the cleanup work, for which the owner of the property would otherwise be liable.

Continuing Indemnities

As mentioned above, indemnities for environmental liabilities are a frequent component of business transactions. Depending on which party agrees to assume a particular risk, the other party will usually require an indemnity, in case the regulators do not impose obligations consistent with the parties' allocation of risks.

Indemnities in business transactions are often limited in time, and there will frequently be a materiality threshold below which no claims will be indemnified. Such provisions can also complicate the allocation of environmental risks.

It is important for parties and solicitors to understand there are often several ways that contamination can be remediated, and the method selected as well as the speed and aggressiveness with which it is carried out can have a tremendous impact on the costs. A system of gradual attenuation will have less interruption of business, and will generally be less costly, but requires a longer period of monitoring and assessment. However, it may not satisfy the above-noted time limitations on indemnities and escrow funds. In such circumstances, a party might be tempted to adjust the speed of a cleanup in order to fit a claim within an indemnity or escrow period. This would increase the overall cost of the remediation, but may be an attractive option for a purchaser if timing has a direct impact on the availability of an indemnity or escrow fund.

In drafting an agreement, parties and their solicitors should adjust for the inherent difficulties in discovering environmental contamination. Special care should be taken to ensure that limitations on obligations to indemnify with respect to environmental issues are suitable to problems of the discoverability of contamination. It will often make sense to extend such periods for environmental issues to continue beyond the shorter limitation periods often provided for in general indemnities.

Co-operation in Remediation

Disputes concerning future remediation decisions are often avoided where there is some degree of ongoing co-operation and sharing of risk built into an agreement, so that both the vendor and the purchaser have an interest in co-operating in order to minimize mutual expenses. While there may be environmental contamination on a site, it does not necessarily always interfere with business operations and may not need to be fully or extensively remediated. Furthermore, there is often a natural attenuation of environmental contamination over time, and thus an aggregate cost savings to the parties in a more gradual approach.

To the extent that a vendor is solely responsible by the contract to clean up a site, a purchaser has an interest in ensuring that the vendor will do as much remediation as possible, even if it is not strictly speaking necessary from an environmental perspective. This is because the remediation will result in an increase in the value of the real estate or property. Some purchasers in these circumstances seem conveniently to develop an enhanced concern for the environment and some even invite regulatory attention. Although this is a risky strategy for a purchaser, it has been known to be used, particularly in a situation where the enterprise sought to be carried out by the purchaser on a property has proved to be uneconomic. Since in that

circumstance there is no ongoing profitable business to protect, the value of the real estate assets is sought to be enhanced by having them cleaned up, even if this disrupts the business. It seems unlikely that Courts would countenance such behaviour, but it would be preferable to take away any incentive to engage in it.

One way for a vendor to prevent such a situation is to insist upon a provision that it obtain as a credit against any indemnity the increased value of the real estate as a result of remediation work to be done. This increase in real estate value is often overlooked by the parties in their original negotiation of a transaction, but it is an important factor that should be taken into account.

Conclusion

Even when parties are fully aware of the risks of environmental contamination, they will undoubtedly assess them differently, depending on the experience of the business, its resources, the nature of the information that it has and the personality and risk aversion of the individuals and institution involved. As a result, what is an unacceptable risk to one party may well be acceptable to the other. The trick in negotiating transactions and in completing them is to identify the risks and information available so that the parties involved can make as informed a decision as is possible, understanding that there are and always will be risks that are not ascertainable.

Environmental issues are often merely one of numerous aspects of a transaction that must be dealt with as "due diligence" concerns, but lawyers and parties make potentially very costly mistakes if they treat them as routine issues that can easily be overcome. In many cases, they have the potential to interfere with the successful completion of proposed business transactions,

and often do. It is important for all parties and solicitors involved to turn their minds to environmental issues at an early stage and plan their strategy accordingly.