Why Due Diligence? The Lawyer's View.

The best answer I ever heard to the question "Why does one do environmental due diligence?" was: "My lender is making me." Of course that's not *the* reason. But it is *a* reason.

Environmental due diligence typically breaks down into two types: (1) researching residual environmental contamination on a property; and (2) evaluating environmental compliance. The second set is more typical when one is buying an operating business. Here, we discuss both.

Assessing environmental contamination

This is the kind of environmental due diligence most of you are familiar with - Phase I environmental site assessment sometimes followed by a Phase II. Primarily, the due diligence is conducted to assess the possibility of environmental liability to pay to cleanup contamination.

Assuming that the property is not regulated under federal or state law relating to the management, transport, or disposal of hazardous waste or toxic materials, if one does a Phase I environmental assessment and finds no indication of "Recognized Environmental Conditions," then, under state and federal law, the inquiry may stop and the buyer is protected from liability by what is known as the due diligence "safe harbor." So, even if it is later determined that the property was contaminated, the buyer would not be liable.

If contamination is suspected, the Phase II ESA will try to confirm its existence. If no contamination is confirmed, the buyer would proceed under that same "safe harbor." If the Phase II confirms contamination, the buyer may walk away and avoid any liability. Otherwise, the buyer may assess the magnitude of the liability and either negotiate with the State or with the seller to try to "box in" their liability.

Under Michigan law, once a buyer has information that the property is contaminated, the buyer may prepare and submit to the state of Michigan a baseline environmental assessment (BEA). The BEA immunizes the purchaser from cleanup liability. Even with such a wonderful "get out of jail free card", the prospective purchaser's evaluation does not stop there. A buyer of a contaminated site will need to exercise "due care" so evaluating what that "due care" will entail is pretty important. Even though a buyer may not be liable for the contamination, its due care obligation may be prohibitively expensive. Knowing that upfront is important. Due care may entail actions as simple as not drinking the groundwater at the property (easy to do if the property is on city water) to retrofitting an existing building with a vapor extraction system to prevent underground fumes from entering the building and posing a risk.

An Aside For lenders:

Under federal and state law, lenders are not held liable for contamination merely because they made a loan or hold a mortgage. So, why should a lender care? A few reasons: (1) they want to be sure that the borrower isn't setting themselves up for liability or catastrophic due care costs which would tank the

loan; (2) if they foreclose on the loan, then the lender may be held liable and they want to be sure they can protect themselves at that time; and (3) if they have to foreclose, they want to be sure that the property has value to a future buyer. So, for example, under Michigan law, a lender doesn't need to do a BEA at the time they make the loan, but they do need to at the time they foreclose.

Environmental Compliance

When buying a going concern (even if an asset deal), you want to be sure that they have all the necessary permits and are in compliance with the permits and the applicable rules and laws. It's that simple. In addition, if there is any possibility that the buyer could be held liable for the seller's past violations (such as through a stock deal or an assumption or indemnification of liabilities), due diligence provides an opportunity to ferret out those liabilities and perhaps resolve them before closing a transaction. For example, there is the opportunity to determine if wastes were sent anywhere that may give rise to Superfund-type liability such as when a business sent wastes to a landfill now under State or Federally-mandated or conducted cleanup, or worse, when wastes were dumped somewhere.

What lawyers need to think about when hiring a Consultant

Know who you are hiring – do not hire just a well-known firm. Often, the biggest and best known environmental consulting firms use low paid entry level staffers to do the bulk of their work and, sometimes, things get missed. Ensure that the consultant hired knows what the transaction is and what you are asking them to do, and why. Sometimes, a consultant will learn something during the course of their investigation that may be useful outside the scope of environmental due diligence. Finally, read the terms and conditions BEFORE hiring the consultant. Most consultants seem to have developed the exact same contract forms and you will find such things as: (1) shortened limitation periods; (2) caps on recovery for breach; (3) limitations to "actual damages" and exclusions of lost profits; and (4) odd or unacceptable dispute resolution provisions. Some firms will negotiate these and others won't. It is important to know who's acceptable to your lender and why and to make sure that the report will be issued to both your client and its lender. You don't want to have to do this twice.

When the report shows up, many will be happy flipping to the conclusions section. However, I find it best to actually read the whole report, ask questions that you think a lender might ask, and be willing to challenge those conclusions. It is better to do so before a lender asks a hard question that neither you nor the consultant can answer on the eve of closing.

Contact Information:

Arthur Siegal, Partner
asiegal@jaffelaw.com
248.727.1452