

Enforcement**Environmental Audits**

This article provides an overview of environmental compliance audits for operating businesses and facilities. ECAs are a vital tool in ensuring environmental regulatory compliance and avoiding penalties. The article explains the advantages of performing an ECA, compares the roles of environmental attorneys and consultants in the process and examines key differences between ECAs and Phase I environmental assessments. The article concludes with practical advice to ensure the continued compliance of a facility or group of facilities after an ECA has been performed.

Environmental Compliance Audits: A Cheap “Insurance Policy” Against Regulatory Entanglements



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Introduction

Being cited for a violation of environmental laws or regulations can be extremely expensive and disruptive to a business. Whether through luck or a relative lack of resources on the part of local or regional environmental regulators, many manufacturers or other industrial facilities are fortunate to have had few, if any, serious brushes with environmental regulators at either the state or federal level. However, that good luck may lull business owners and managers into a false sense of security if they assume that because no environmental inspectors have ever knocked at the door, there are no significant environmental compliance issues waiting to bubble up to the surface (no pun intended).

“We’ve been doing the same thing in the same place, the same way, for (10 years? 20 years? Longer?) and we’ve never had any problems, so why worry?” is a common response when someone suggests an Environmental Compliance Audit (ECA) might be a good idea. Especially in this age of lean manufacturing practices and tight profit margins, the notion of paying lawyers

and consultants to perform an ECA when an obvious environmental compliance problem hasn't been identified can be a very hard sell.

Additionally, while ECAs are important for single facilities to ensure environmental compliance and avoid penalties, the significance of ECAs can be multiplied several-fold when an entity seeks to acquire a portfolio of many facilities as part of a typical merger/acquisition (M&A) transaction. In the M&A context, ECAs also may not be performed due to cost or timing considerations, but they also simply can be overlooked if the front line "deal team" lacks the expertise to understand the importance of ECAs to protect against inadvertently acquiring unknown compliance issues and liabilities.

(a) Why Perform an ECA?

So, why perform an ECA, especially if environmental compliance issues have never come up before? As explained below, there are many benefits to performing an ECA, but simply put, it can be a cheap (but not fool-proof) "insurance policy" against major environmental violations first being discovered (often at very inconvenient times) by regulators. Such violations can lead to payment of five, six or even seven-figure civil penalties, distract from a company's operations and focus, involve seemingly endless legal entanglements with the regulators and even result in shutdowns of a business or facility. In the most extreme cases, criminal penalties may be asserted against individuals who willfully violate environmental laws or regulations—or even corporate officers who may have had no direct knowledge of intentional environmental violations but nevertheless ultimately were the "responsible corporate official" in the eyes of the regulators.

ECAs are equally advisable when acquiring a company or business unit that engages in any type of manufacturing or industrial operations. Without such an inquiry (which is preferably performed as part of the pre-acquisition due diligence), it is difficult to assess whether a newly acquired business is prepared to successfully withstand an environmental inspection or only a few weeks away from a shutdown or penalties if the inspectors come knocking post-acquisition. It also often is much easier to include a budget for pre-acquisition due diligence into the scope of the overall deal than try to find money for such an investigation later on, when such costs usually are allocated to each facility's financial performance criteria. Perhaps most importantly, however, without a pre-acquisition ECA, if significant future costs are involved in bringing the facility into compliance, the chance to price the cost of such latent environmental compliance into the deal probably will be lost.

The good news is that performing an ECA usually is a relatively straightforward—and not overly expensive—process that can be completed fairly quickly and pay enormous dividends, especially if significant issues are identified and corrected, before the regulators are ever the wiser.

(b) Getting the Right Professionals Involved: Attorneys and Consultants

Typically, to perform an ECA on a facility or group of facilities, an environmental consultant with experience in performing such audits is engaged. Obviously, a consultant who has specific familiarity with the particular industry or operation at issue is preferable. Because ECAs require a firsthand inspection of the facility (or facilities) or operations by the consultant, larger national or even multinational operations with many facilities may require retaining a consultant with sufficient personnel and geographic reach to complete the project, especially if timing is an issue (as it often is in acquisitions).

While such a consultant can be hired directly by the company, there often are significant advantages to first engaging an environmental attorney to advise on the specific circumstances of the company's operations and help develop the appropriate scope of the ECA. Aside from the benefit of experience and strategic thinking that an experienced environmental attorney can provide, the most significant benefit is the ability of the attorney to protect the results of the audit from unwanted disclosure to government regulators (even in the context of enforcement litigation), using the principles of the attorney-client privilege and the attorney work-product doctrine. Without such protection, sensitive ECA results typically can be requested and obtained by regulators in the context of an inspection and/or enforcement action through statutory document or discovery requests.

While some companies (especially those in highly regulated industries) already may have experienced environmental counsel in-house, there still is a significant advantage to retaining outside environmental counsel to engage and supervise the consultant. This is because it has proved difficult for some courts to distinguish the activities of in-house counsel between acting as a legal advisor to the company and as a "business consultant." Indeed, as the pressure increases for in-house counsel to serve as business advisors—not just legal advisors—judges increasingly may be uncomfortable ruling that an internal lawyer is acting as a legal advisor when arranging for an ECA (in which case the conventions of attorney-client privilege and attorney work-product apply), as opposed to acting as a business advisor (in which case such protections typically do not). Thus, the safer course of action is first to retain experienced outside environmental counsel (even if they closely coordinate with inside environmental counsel), who then will retain the environmental consultant.

In addition to maximizing the probability that legal privileges and protections against disclosure will apply to the ECA, the environmental attorney also can review the consultant's proposed contract and ensure the terms and conditions of the retention are acceptable. For example, most consultants try to limit their professional liability to the value of the contract, which isn't favorable to the client. Most often, however, the consul-

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tant will agree to a professional negligence liability limitation to the limit of their insurance policies (the minimum amounts of which also should be spelled out in the agreement).

Defining the scope of the ECA also is important. Which facility (or facilities) will be covered, the time frame for performing the ECA, and providing a draft report for attorney review and the standard to which the ECA will be performed (ASTM Practice E2107-06, "Standard Practice for Environmental Regulatory Audits" is a useful and common reference) should be specified by the consultant and approved by the client and attorney.

Finally, the cost for the ECA also should be established. Pay close attention to the proposed cost; some consultants will provide a "budget" or "estimate" but may not guarantee not to exceed that cost unless a fixed-fee, not-to-exceed price is negotiated up front.

(c) Performing an ECA

How is an ECA performed? Most often, after retention of a competent consultant through experienced environmental counsel, the consultant will provide the plant manager or other responsible corporate official with a "pre-inspection checklist." This checklist is intended to provide the consultant with basic information, such as the environmental permits that a facility has (e.g., air permits, water pre-treatment permits, hazardous waste storage or management, etc.); what laws and regulations it is presumed are relevant to that facility (e.g., hazardous chemical storage reporting and disclosure); documentation maintained and/or submitted by the facility (e.g., "Tier II" reporting for storage of large amounts of chemicals, Safety Data Sheets (SDSs) (formerly known as Material Safety Data Sheets (MSDSs)); spill plans; and emergency response plans.

After review of the completed pre-inspection checklist, the consultant will conduct a walk-through and document review at the facility. During the walk-through, the consultant will look for circumstances of compliance and noncompliance based on their experience in assessing compliance at industrial facilities. For example, some of the many issues a consultant commonly will investigate are:

- *Does the facility have operations that generate hazardous waste?* In that case, the consultant will determine if the hazardous waste is correctly managed, stored, labeled, stored and properly/timely shipped off-site for recycling or disposal.

- *Are environmental records and information properly maintained and submitted to regulators (where appropriate)?* Many facilities must file inventory reports for large or extremely hazardous quantities of chemicals used at the facility, as well as maintain spill plans, contingency plans, SDSs and other hazard communication documentation. SDSs in particular not only must be maintained for most chemicals used at facility but also must be available for review at all times by facility personnel.

- *Does the facility have industrial equipment or operations that emit gases or vapors?* The consultant will review whether the facility is required to have air permits and whether they are appropriate for the types and amounts of emissions, which may depend heavily on the state or region where the facility is located.

- *Can the facility easily be expanded in the future?* A good consultant can provide guidance on whether the current operations can be expanded/increased under applicable environmental laws, particularly in the air regulatory arena.

Many less obvious specific compliance issues also can be identified by an experienced consultant. For example, if the facility contains lead-acid battery powered forklifts, it takes only a few such batteries (which typically each weigh in the thousands of pounds) to trigger reporting requirements under the federal Emergency Planning and Community Right-to-Know Act (42 U.S.C. §§ 11001-11050) for the lead and sulfuric acid contained in such batteries.

This type of reporting is required regardless of the overall nature of the facility operations; rather, it is the amount of chemicals stored or used at the facility (even those in self-contained units, such as sealed batteries). Many facilities that never have had a significant environmental noncompliance issue have been hit for six-figure penalty demands for failure to report lead-acid batteries in exactly that circumstance. Finally, it should be noted that lead-acid batteries aren't just for forklifts anymore. Many facilities that feature Uninterruptable Power Service (UPS) systems, especially data centers, contain many smaller lead-acid batteries hooked up in series, which in the aggregate also can trigger EPCRA reporting requirements.

Just as critical as the site walk-through is the review of environmental records, including reports to regulatory authorities and any permits the facility has. Many times the facility looks very clean, but failure to file and maintain the proper paperwork to comply with permitting and reporting requirements can result in problems and penalties just as severe as for mismanaging waste or other, more obvious issues. The consultant will review the facility's operations and ensure any reporting obligations, as well as permits, properly have been fulfilled and adhered to.

After the site visit, the consultant will write up an audit report that will summarize the tasks performed, including the results of the site visit and document review, and provide a set of conclusions and recommendations. The best practice is first to request a draft report to be reviewed by the environmental attorney. The draft clearly should be labeled "Confidential and Privileged: Attorney Work-Product Produced at Request of Counsel in Anticipation of Litigation" or something similar, according to your attorney's specific advice.

Once the draft report is finalized, management can determine which, if any, of the consultant's findings and recommendations require action or other response. Such actions could include changing waste management practices, applying for air permits or filing missing chemical inventory reports. Management, in consultation with the environmental attorney, can decide whether to fix the problem(s) "quietly" or self-disclose the violations to the applicable regulatory authorities (federal, state and/or local) to take advantage of penalty mitigation or immunity policies and laws that may be available to encourage such self-disclosure, depending on the jurisdiction.

(d) Self-Disclosure of Environmental Violations

As noted above, the U.S. Environmental Protection Agency and many state environmental protection authorities provide (through statute, regulation or policy) a pathway to significantly mitigate or eliminate the typical penalties that otherwise would be assessed, based on self-disclosure of violations discovered through the course of an environmental compliance audit. While the specific rules vary from jurisdiction to jurisdiction, among other criteria, noncompliance issue typically must be discovered in the course of a voluntary self-audit; the discovery of the violation must not have been the result of a statutorily required or court-ordered inspection; and the violation promptly must be disclosed to the applicable regulatory authority. After disclosure, the violations promptly must be rectified to qualify.

The EPA also provides a specific self-disclosure option when a company is acquired by “new owners,” which gives the acquiring entity a chance to start with a “clean slate” by disclosing the environmental noncompliance issues and then moving quickly to come into compliance. A specific window for such investigation and disclosure is available that spans both the pre-acquisition and post-acquisition period, but it is limited and finite. Acquiring entities even can approach the EPA prior to acquiring a company and negotiate customized timing and scope of an ECA specific to the transaction, which can be especially helpful.

The prerequisites and procedures that must be followed under each of the federal and (where available) state schemes are complex and require strict adherence to ensure a voluntary self-disclosure will qualify for the penalty mitigation benefits. Among other issues, it should be noted that in some states don't require submission of the ECA to reap the benefits of the self-disclosure policy (although failure to submit typically would waive any privileges unless that state provides a specific statutory exception to the contrary).

A complete discussion of the intricacies of the self-disclosure policies of the federal government and applicable states is beyond the scope of this article, so experienced environmental counsel should be consulted before an audit is disclosed to regulatory authorities.

(e) What's the Difference Between a Phase I and an ECA?

Many facility owners and operators may be familiar with a “Phase I” Environmental Site Assessment. A Phase I is typically used to perform environmental due diligence prior to acquiring title to a piece of real property that may or may not be improved with a building or other structures. See ASTM Practice E1527-13. Performing a Phase I often is used to establish “All Appropriate Inquiry,” which is a requirement for asserting certain defenses under the Comprehensive Environmental Response, Compensation, and Liability Act (42 U.S.C. § 9601 et seq.), such as the “Bona Fide Prospective Purchaser” defense.

However, it is dangerous to assume that performing a Phase I on a facility is equivalent to an ECA when there is an operating facility on the parcel of real estate that is the subject of the Phase I. Typically, the scope of a Phase I is limited to identifying “Recognized Environmental Conditions” (RECs) that would suggest the release of hazardous substances and/or petroleum on the

property. While a consultant performing a Phase I on a property that includes a facility operating as a going concern generally would walk through the facility looking for evidence of RECs, such a consultant normally isn't expected to review facility environmental records, evaluate the sufficiency and scope of required environmental permits or make recommendations with respect to identified regulatory noncompliance issues. Thus, for any acquisition of real property that includes an operating industrial or manufacturing facility, performance of an ECA *in addition to* a standard Phase I is essential.

(f) Beware of ‘Zombies’

Interestingly, in the M&A context, not only does an acquiring entity have to worry about environmental compliance for current operating facilities, but sometimes facilities that have been closed and/or sold off for years also may come into play. Typically, this situation arises when the stock of an entire larger industrial company is being purchased, because such companies often have a long history of operation at multiple plant sites, some or many of which now are defunct and no longer owned by the company. Such sites, known as “zombies,” may in fact come back to haunt the purchaser of the target company, as the target company still can be legally responsible for its historic operations on such sites to the extent such operations caused pollution or violated environmental laws.

Typically, an ECA only will cover current operating facilities, but the scope of an ECA can be expanded to include research of information regarding former facilities as well. However, such research can be expensive and time-consuming, which may render such an expanded scope a fairly impractical option. In such cases, environmental insurance commonly known as “zombie insurance” can provide unscheduled coverage for formerly owned and operated locations that “come back from the dead” after the transaction due to recently discovered environmental issues.

Finally, it should be noted that while liabilities generally follow stock purchases and not asset-only purchases, designing the transaction as a sale of assets and not stock isn't necessarily a guarantee against future environmental liability passing on to the acquiring company under legal principles such as “de facto merger,” “substantial continuity” and related concepts.

(g) Conclusion

ECAs can be extremely useful to your company or client to confirm that a particular facility or group of facilities is in compliance with all applicable environmental laws and regulations. By engaging a suitable and experienced consultant through outside environmental counsel to perform an ECA, if noncompliance issues are identified, a decision then can be made whether to voluntarily self-disclose such violations to the regulatory authorities and attempt to take advantage of federal and/or state self-disclosure laws.

After the facility has come into compliance, it is a good idea to set up a periodic environmental audit schedule, typically on a yearly basis. If problems do arise in the future, not only will you be able to identify and address them more quickly, but regulatory authorities typically are more lenient with operations that have a robust environmental management and audit protocol. The best news is that once the initial audit has been performed and the major problems addressed, it is gen-

erally less critical to involve an environmental attorney in subsequent periodic audits.

In sum, the opportunity to discover significant environmental violations before the regulators find you

(and also possibly get a break on penalties by self-disclosing such violations) is well worth considering for the relatively nominal investment in professional assistance (attorneys and consultants) required.