ENVIRONMENTAL DUE DILIGENCE FOR CORPORATE ACQUISITIONS

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For most companies, the decision to acquire part or all of another company is a major undertaking that occurs infrequently at best. Temptingly, buying another company can accomplish instant expansion, the acquisition of important product lines or brands, acquisition of key employees, customers, or contracts, and/or rapidly increase market share (especially with the acquisition of a competitor). However, with such high potential rewards, such moves often come with significant risks. Generally, from the legal perspective, when one company buys another company (that is, the acquiring company purchases all of the stock of the target company), that means that the purchaser acquires all of the liabilities of the target company. In other words, the purchaser is buying not only the company as it exists at that time, but it also acquires (for better or worse) the entire history of the target company's operations.

With very few exceptions, most companies (especially smaller ones) are not well-versed in dealing with the many issues that arise in the course of a corporate acquisition. Significant issues such as personnel matters, ownership of intellectual property (e.g., company name, brand names, websites, customer lists, patents and goodwill), real estate and facilities, customer/vendor contracts, corporate financial condition and potential latent liabilities, all pose unquantified risks that must be researched and dealt with in the course of conducting "due diligence" on the target company.

One often-overlooked aspect is environmental due diligence, which is accomplished in several different ways. Some involve physical site visits and investigations, and some require researching corporate compliance history and liability. Often, the investigation results drive the terms of the deal and implicate contractual provisions between the buyer and seller such as indemnities, express assumptions of environmental liability, covenants not-to-sue and releases, and even environmental insurance products, to help manage and mitigate identified risks.

For starters, many people are already aware that when acquiring real property, a "Phase I" Environmental Site Assessment (ESA) is highly recommended – both for ascertaining any potential problems that could pose significant risks (as well as providing the chance to identify and factor those risks into the purchase price) and also for establishing certain statutory defenses to environmental liability (such as the "Bona Fide Prospective Purchaser Defense" under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA," aka "Superfund"), 42 U.S.C. § 6901, et seq.). Many corporate acquisitions will include one or more properties (often with operating facilities) that should each be evaluated with its own specific Phase I ESA (or together as a portfolio). It should be noted that if institutional financing (i.e., a bank) is involved, the lender will almost certainly insist on a Phase I ESA for each and every parcel of real estate.

But, environmental due diligence for a corporate acquisition most often needs to go beyond a basic Phase I ESA, which is primarily focused on the conditions of the property itself – for example, investigating past uses of the property (though historical aerial photographs, city directories, fire insurance maps and other tools) and physical signs of potential contamination (stained soils or surfaces, vent pipes for underground storage tanks, pits or sumps in the facility, etc.). Typically, because most corporate acquisitions involve operating facilities and businesses, an Environmental Compliance Audit (ECA) is needed in addition to the Phase I ESA.

An ECA picks up where a Phase I ESA typically leaves off and focuses on the business as a going concern, and whether the company (or specific facility) is operating with the proper environmental permits (e.g., air emissions, outfalls or sewer discharges), is in compliance with environmental laws and regulations (for example, hazardous waste management), and whether the company or facility is under threat of enforcement or litigation for any non-compliance issues. An ECA will evaluate whether the current operations pose any problems or whether the company has a recent history of violations.

For example, a facility with a plating line could have numerous recent permit violations and is in danger of being shut down by the applicable environmental authorities – but without a proper ECA, this situation could go unidentified until months after the purchase of the company is consummated (at which point substantial penalties could be assessed, or even an unanticipated shutdown by the regulators could occur). Or, a facility might be operating without proper permitting at all – for example, a printing shop that is required to have air permits for its volatile emissions coming from the printing presses, or a parts manufacturer that needs a permit for its spray paint booth. Other compliance problems besides adhering to permit conditions can be found when environmental regulations govern operational aspects, such as hazardous waste management, that don't require a permit but are subject to many requirements for proper handling and manifesting of waste transportation and disposal.

A much more difficult, but still very important, aspect of potential environmental liability stems from facilities that a target company may have owned in the past, but sold off years ago. For example, consider a company that at one point had 10 different facilities, but recently sold off half of them – such that when the company became an acquisition target, only five facilities were

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owned and operational. While a proper set of Phase I ESAs and even Compliance Audits on the facilities will give a good snapshot of the environmental condition and compliance status of the current facilities, such investigations typically do not include former facilities that a company at one time owned and/or operated. Such facilities are sometimes referred to as "zombies," in that they can sometimes come back from the dead to haunt an acquiring company with unexpected environmental liability. Researching whether such former facilities could implicate present-day liability to the target company (which could then inure to the acquiring company) is difficult, time-consuming and expensive, although specific environmental insurance policies can be obtained that specifically cover the risk posed by "zombie" facilities.

Another hard-to-research issue is the prior actions of the target company as to managing its hazardous waste. Many companies historically managed their hazardous waste by sending it offsite for disposal – either in a dump or landfill the company controlled, or through a third-party landfill operator. Even if the waste was managed according to the standards of the time, however, advances in the understanding of how buried waste can affect the environment by contaminating groundwater or similar issues can implicate a current problem that needs to be addressed to protect the environment. Often, the company that sent its waste for offsite disposal can be tagged for liability by environmental authorities, even if the company's actions were completely legal at the time. Because this is also a difficult problem to assess in the course of environmental due diligence, another insurance product called "Non-Owned Disposal Sites" or "NODS" insurance can help mitigate that risk.

As noted above, the general rule is that liabilities follow the purchase of stock – in other words, when a purchasing company acquires all of the stock of a target company, the purchaser essentially becomes the target company (although some targets may be maintained as a legally separate subsidiary that may help to shield the parent from liability to some degree). For this reason, many corporate acquisitions are styled as "asset purchases," where instead of buying all of the stock of a target company, only the desirable assets are purchased. Legally, liabilities do not follow the purchase of mere assets – the target corporation's liabilities remain with the target corporation, which maintains its legal existence.

However, in practice, most often virtually all of the assets of the target company are purchased (for example, the name, the logo, the website, the customer lists, the products, the accounts receivable and accounts payable, other intellectual property, etc.). The target corporation is left with only a shell, which typically undergoes a name change (to allow the original name to be purchased by the acquiring company), and then the target corporation shell is formally dissolved fairly quickly. At that point, the company is deemed "dead" but is still legally in existence to allow it to be sued for liabilities related to its corporate lifetime. Then after a statutorily-defined time (that differs from state to state, but is usually between two and five years), the dissolved company is deemed "dead and buried" and is no longer susceptible to lawsuits (except in certain cases where fraud or other malfeasance is alleged). Once the company is "dead and buried," whatever environmental liabilities may have attached to it go "poof."

Because the courts typically do not like situations where a potentially liable company can no longer be sued for its actions, especially where a new company has come in and bought all of the "good" assets (leaving the liabilities with the shell of the target company), a number of legal doctrines have developed over the years that can hold the buyer company liable for the prior actions of the target company, even in the case of an asset-only sale. These doctrines, with various names such as "mere continuation" and "substantial continuity" may allow (depending on the jurisdiction) claims to be brought against the asset purchaser (especially where the selling company's stockholders are paid with stock of the buying company, thereby establishing some continuity of ownership). Thus, environmental due diligence is still important, even for a typical "asset-only" purchase.

Moreover, in practice, sometimes a deal simply cannot be structured as an asset purchase because some of the desired assets may be customer contracts (especially those with governmental agencies) that cannot be assigned, and/or permits, licenses or other contractual relationships that cannot unilaterally be sold or transferred to a different entity.

Once the environmental due diligence is performed, the risks are ascertained and, to the best degree possible, quantified, those risks can be allocated in the context of the deal. For example, if the owners of a selling corporation agree to remain liable for any environmental liabilities that may have inured prior to closing on the deal (even if such liabilities are unknown at that time), the seller can agree to indemnify the buyer. The risk there, of course, is that collecting on the indemnity may be problematic, especially if years pass and the indemnifying corporation dissolves, and the stockholders disperse their assets. However, sometimes this risk can be insured against with an 'excess of indemnity' policy. Representations and warranties from the seller as to environmental issues can also help, but are generally not a substitute for due diligence for the same reason (although insurance can also cover reps and warranties). Other contractual "tools" such as releases and covenants-not-to-sue, and express assumptions of environmental liability, can also be used to clearly define where the parties wish the environmental risks to reside at the end of the deal.

In sum, while making a corporate acquisition can be an important and useful strategy for rapid growth, the risks inherent in such a transaction must be thoroughly investigated through proper environmental due diligence conducted by a qualified team of environmental consultants, attorneys and other professionals. ◆