NEW RULES AFFECT ENVIRONMENTAL DUE DILIGENCE

Effective November 1, 2006, prospective purchasers of real property who wish to preserve key defenses to federal cleanup liability must follow environmental due diligence regulations issued by the U.S. Environmental Protection Agency ("EPA"). These regulations, codified at 40 C.F.R. § 312 (2005), are commonly known as the All Appropriate Inquiries Rule (the "AAI Rule").[1] The AAI Rule, after which the industry standard known as ASTM E1527-05 is modeled, sets forth the pre-acquisition diligence that a purchaser must perform in order to be eligible for certain defenses to environmental cleanup liability under the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA" or "Superfund").

In comparison to ASTM E1527-00, the prior industry standard for preparing Phase I Environmental Site Assessments ("ESAs"), the AAI Rule includes more detailed criteria regarding the requisite qualifications of an "environmental professional" hired to conduct a Phase I ESA; additional interviewing, site reconnaissance, and records research requirements; and an increased emphasis on data quality. The AAI Rule is not, however, a "one-size-fits-all" legal requirement, but rather a due diligence standard that purchasers may choose to apply on a case-by-case basis depending on their objectives. The decision regarding whether to follow the AAI Rule may turn on whether preserving certain CERCLA defenses is a priority; the purchaser's risk tolerance; confidentiality concerns; and the increased costs, burdens, and time that may be involved in meeting the AAI Rule's requirements. Furthermore, the prospective purchaser should keep in mind that following the AAI Rule is only a threshold factor in qualifying for federal liability protections and that preserving such defenses may require compliance with certain ongoing post-acquisition obligations. Therefore, a case-specific cost/benefit analysis may assist purchasers when deciding whether to follow the AAI Rule.

I. Background

Congress passed the Small Business Liability Relief and Brownfields Revitalization Act in 2002. Among other things, this law included amendments to CERCLA that created, for the first time, CERCLA liability defenses for persons purchasing property with knowledge that the property is contaminated. Specifically, the law created two new liability protections, known as the contiguous property owner defense and the bona fide prospective purchaser defense. In order to qualify for such defenses (or the traditional innocent landowner defense), however, prospective purchasers are required to undertake pre-acquisition "all appropriate inquiries" into the property's previous ownership and uses. EPA was assigned the task of establishing the standards and practices for satisfying the "all appropriate inquiries" requirement; and in 2005, EPA promulgated the AAI Rule in coordination with ASTM International's release of industry standard ASTM E1527-05 for Phase

[1] See 40 C.F.R. § 312 (2005) ("All Appropriate Inquiries" Rule), available at http://www.epa.gov/swerosps/bf/aai/aai_final_rule.pdf.

I ESAs.[2] The AAI Rule became effective on November 1, 2006, as the first federal government standard for conducting a Phase I ESA.[3]

II. Changes to the Preparation of Phase I ESAs Precipitated by the AAI Rule

There are a number of novel requirements included in the AAI Rule. As a threshold matter, the rule emphasizes the use of a qualified "environmental professional" for supervising the Phase I ESA preparation process. An individual may be deemed an "environmental professional" if he or she has a certain combination of education, certifications, and/or experience. For instance, both an individual with a bachelor of science degree and five years of experience and an individual with a professional engineering license and three years of experience qualify.

In accordance with its overall objective of documenting conditions indicative of releases or threatened releases, the AAI Rule requires the preparation of a written report. This report must be based upon a number of additional due diligence steps intended to more fully characterize past and present uses than did reports under prior ASTM standards. Key examples pertain to the following:

- ***Environmental Professional's Declaration.*** The environmental professional is required to include a signed statement (verbatim as set forth in 40 C.F.R. § 312.21(d)) in the Phase I ESA certifying that he or she meets the regulatory definition of "environmental professional" and that he or she evaluated the property in accordance with the AAI Rule.
- ***Interviews.*** Current property owners and occupants now *must* be interviewed to collect information about the property, including without limitation past uses of the property and conditions that may indicate releases or threatened releases. Interviews of other persons, such as prior owners and occupants, are required if such persons are likely to have additional material information. If a property is abandoned, at least one nearby property owner or occupant must be interviewed.
- ***Records Searches.*** The government records review now *must* include tribal and local (in addition to federal and state) records and identify all activity and use limitations (i.e., engineering and institutional controls).
- ***Property Inspections.*** Adjoining properties now *must* be visually inspected to the extent observable from the property line, a public right-of-way, or a similar vantage point.

[2] As EPA has stated in guidance documents, "[t]he new ASTM E1527-05 Phase I Environmental Site Assessment Standard is consistent and compliant with EPA's final rule and may be used to comply with the provisions of the all appropriate inquiries final rule." See U.S. Environmental Protection Agency, *Comparison of the Final All Appropriate Inquiries Standard and the ASTM E1527-00 Environmental Site Assessment Standard*, Oct. 2005, available at http://www.epa.gov/brownfields/aai/compare_astm.pdf.

[3] Certain states have enacted due diligence criteria for preserving defenses to environmental cleanup liability under state law.

- ***Data Quality.*** The environmental professional preparing a Phase I ESA must comment upon the significance of any data gaps and identify information sources consulted to address such data gaps. In addition, the environmental professional must provide an opinion regarding additional appropriate investigations that may be necessary, if any, to more fully characterize environmental conditions on the property. Finally, there is also a new emphasis on ensuring that Phase I ESAs are up to date at the time that a transaction closes. Therefore, while the "shelf life" of a previously prepared Phase I ESA is generally one year, certain components such as interviews, records searches, visual inspections, and the environmental professional's declaration must have been conducted or updated within 180 days prior to the acquisition.
- ***Purchaser's Obligations.*** Before the AAI Rule, prospective purchasers were required to undertake a search of reasonably ascertainable land title records for environmental cleanup liens and disclose such information to the consultant preparing the Phase I ESA. The AAI Rule now permits either the purchaser *or* the environmental professional to undertake such a search, which *must* include environmental cleanup liens filed or recorded against the property under federal, tribal, state, or local law. Prior to the AAI Rule, prospective purchasers also were required to consider any specialized knowledge or experience of the purchaser and a comparison of the purchase price to the fair market value of the subject property if the property were not contaminated. In addition to these obligations, the AAI Rule now requires both the purchaser *and* the environmental professional to take into account any "commonly known or reasonably ascertainable information within the local community about the subject property." This may include information from a variety of sources such as newspapers, local or state government officials, community organizations, and websites. A key difference under the AAI Rule versus prior practice is that the purchaser is not required to disclose any of the above categories of information to the environmental professional. Should the purchaser not disclose any such information, however, the environmental professional must treat such nondisclosure as a data gap and comment on its impact upon the environmental professional's ability to assess the property.

III. Factors to Consider When Deciding Whether to Apply the AAI Rule

Following the AAI Rule when undertaking environmental due diligence may not be appropriate in all circumstances and deciding whether to do so may be based upon a range of factors. Some points to consider include the following:

- ***CERCLA liability defenses are limited in their scope.*** Following the AAI Rule provides eligibility for defenses against CERCLA liability only. These protections do not apply to potential liability under other federal laws, such as the Resource Conservation and Recovery Act; common law causes of action; or state, local, tribal, and foreign laws.

- ***Satisfying the AAI Rule does not automatically qualify a purchaser for CERCLA liability protections.*** As a threshold matter, in order to qualify for CERCLA defenses, the purchaser cannot in any way have been responsible for releases or threatened releases on the subject property. In equity deals, such as mergers and stock purchases, a purchaser may not be permitted to invoke the CERCLA liability defenses if such purchaser is deemed to have stepped into the shoes of the pre-transaction owner. Furthermore, after the property acquisition is completed, the purchaser may be required to comply with certain continuing obligations in order to preserve the CERCLA liability defenses. These may include complying with activity and use restrictions; reporting releases; taking reasonable steps to stop any continuing release, prevent any threatened future release, and prevent or limit exposure to a previous release; cooperating with and providing access to those authorized to address actual or threatened releases; and responding to CERCLA requests for information.
- ***Even when CERCLA liability is not a concern, the AAI Rule may be adopted as a general due diligence guideline.*** Since the AAI Rule matches up with ASTM E1527-05, parties accustomed to following ASTM may begin to use the AAI Rule as a general starting point for environmental due diligence. For example, while lenders are generally shielded by secured creditor protections under CERCLA, they may require that the AAI Rule be followed due to concerns over exposure to significant environmental liabilities should they obtain title to a property through foreclosure.[4] Wall Street's ratings of a public company also may take into account the thoroughness of environmental due diligence conducted for property acquisitions.
- ***Other considerations may influence whether to follow the AAI Rule.*** Depending upon the nature of the transaction, deciding whether to adhere to the AAI Rule may involve certain case-specific factors. For example, strict confidentiality for the prospective transaction may be difficult to maintain if certain requirements of the AAI Rule, such as conducting interviews, are to be met. If the user wishes to place materiality thresholds upon a Phase I ESA's scope of review, it will likely run afoul of the AAI Rule. Meanwhile, preparing an AAI-compliant Phase I ESA may be time-consuming and require increased costs. As mentioned above, there are several additional steps involved in following the AAI Rule and, according to one estimate, an AAI-compliant Phase I ESA may cost $430 more on average than a traditional Phase I ESA.[5] Notably, this does not include the costs of any additional investigations that may now follow from the environmental professional's AAI-required opinion on data gaps, nor the cost of other steps necessary to properly characterize environmental conditions.

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[4] The Federal Deposit Insurance Corporation ("FDIC") recently issued guidance advising that "[t]he [lending] institution's policies and procedures should reflect adequate consideration of the Environmental Protection Agency's (EPA) 'All Appropriate Inquiry Rule.'" See *Guidelines for an Environmental Risk Program*, available at http://www.fdic.gov/news/news/financial/2006/fil06098a.pdf.

[5] Webcast Seminar, "EPA's New Rule: What it Means to Corporations," Environmental Data Resources Inc., Dec. 14, 2006.

Ultimately, deciding whether to follow the AAI Rule requires an understanding of the AAI Rule's requirements, potential advantages and disadvantages, and applicability to the particular property or transaction at issue. This requires a case-by-case cost/benefit analysis of the factual, legal, and business issues, including the risk tolerance of the various parties involved in the transaction. Moreover, the acquirer may wish to examine certain factors not considered in an AAI-compliant Phase I ESA that can present a risk of significant liability or property impairment, such as wetlands, endangered species, radon, asbestos, vapor intrusion, mold, lead-based paint, and environmental compliance. Accordingly, it is important to become familiar with the AAI Rule and to obtain guidance from environmental professionals and legal counsel when developing a scope of work for environmental due diligence and when assessing whether to prepare or require an AAI-compliant Phase I ESA.

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If you have any questions about this memorandum, please contact E. Donald Elliott (202-303-1120, delliott@willkie.com), Carolyn W. Conkling (202-303-1107, cconkling@willkie.com), Kevin J. Klesh (212-728-8520, kklesh@willkie.com), Ari Altman (202-303-1140, aaltman@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, D.C. 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

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