The Top Ten Pitfalls of Environmental Audits and How to Avoid Them

As the old adage goes, experience is the only time one is given the test first and taught the lesson afterward. This article has been prepared in the hopes of providing the reader a study guide before the test in the area of environmental audits.

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Capmar, Inc.* was jubilantly celebrating its acquisition of Oxford Industries.* Capmar had coveted Oxford* for many years and considered it a prime acquisition in its business plan to become the market leader. This acquisition was doubly sweet because Capmar had helplessly stood on the sidelines several years ago when Oxford was acquired by a large conglomerate in a leveraged buyout. Now it seemed that Capmar's long awaited business expansion was about to take off. While Oxford had identified substantial set-asides for environmental liability, Capmar had included these considerations in its offer and was secure in its estimation that the acquisition would result in substantial positive bottom-line impact. Capmar was correct about the impact; incorrect about the direction.

Several months into the consolidation of the acquisition, Capmar began to uncover troubling indications as to the actual extent of liability associated with Oxford. One of their sites had undefined, but probably extensive, offsite contamination. In fact, the consultants who had worked on the project through the previous changes of ownership considered it one of their worst sites and potentially the worst site on which they had ever worked, including several Superfund sites. It began to look as if the overall environmental liabilities at Oxford could eventually run five to seven times the number Oxford had identified and Capmar had relied on for the acquisition. Facing an unexpected financial drain, Capmar took the only course of action possible; they fired the consultants.

How did this happen? Capmar had performed extensive environmental due diligence. True, they had not asked to speak to the consultants, but they had reviewed boxes and boxes of information. They knew the industry and the potential environmental issues. Fifteen or 20 years ago such an outcome would be considered bad luck, but business understands that managing environmental liability is now a routine part of doing business. Prepurchase/acquisition environmental assessments are common practice.

This was not always the case. The environmental condition of property was rarely, if ever, considered until the 1970s. Caveat emptor was the rule of the day. Such names as Love Canal and Times Beach changed all this. Environmental legislation, including the Resource Conservation Recovery Act (RCRA) and the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), served to bring the

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*The names of the companies and individuals and some of the details of these case studies have been altered to ensure anonymity, but the occurrences on which they are based are real and represent some very hard-learned lessons.

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issue of continuing environmental liability home to the business and financial communities. Legal rulings in which the courts held property owners and financial institutions accountable for the site cleanup on the grounds that they ought to have known of the liability associated with their purchases further whittled away at the innocent land owner defense and confirmed that "what you did not know could in fact hurt you."

The environmental audit or Phase I Assessment, depending on who was describing it, was the tool developed to help the business, legal, and financial communities assess and manage these newly understood risks. This Phase I Assessment could then be followed by a limited/targeted Phase II assessment or environmental site investigation to determine if the potential risks were real or to more accurately define potential liability. However, from the beginning, the quality, content, and accuracy of these audits varied greatly. In 1993 the American Society of Testing and Materials (ASTM), in response to these early problems and in order to define a standard for claiming the innocent landowner defense, developed an audit specification that set a standard of practice for the industry. Certainly prepurchase/acquisition auditing can no longer be considered a new field of practice. However, there are still multiple potential pitfalls within the audit process, and these pitfalls can be extremely expensive, not just in terms of money, but in lost time and opportunity. Customers who are unaware of these potential pitfalls can find themselves in Capmar's shoes.

RELYING ON LIABILITIES DEFINED BY THE SELLER

With Securities and Exchange Commission 10K reporting requirements and financial assurance filings often required by regulatory agencies as well as internal planning requirements, most corporations have identified and to some extent quantified their potential environmental liabilities. However, the underlying assumptions used to develop these cost estimates can vary. Best case, worst case, or most likely case; on-site or off-site; past practices or only current practices, for example, reflect only some of the considerations that may have gone into the development of the identified potential liability dollars. These assumptions may not be explicitly spelled out, as Capmar found out. Capmar had relied on liabilities defined by Oxford. Because the dollar amounts were very high, Capmar concluded that Oxford's identification of potential liabilities was fairly complete and accurate. Capmar had a false sense of security with the high dollar values placed on the liabilities and had not done an extensive independent evaluation of the set-asides. Had they had an experienced environmental professional evaluate these issues and provide a range from best to worst case, Capmar would have realized that Oxford's numbers were more reflective of the best-case scenarios, which indeed was born out when further investigation more clearly defined the liabilities.

RELYING SOLELY ON ASSESSMENTS PROVIDED BY THE SELLER

Often the seller has assessments that have been performed in the past or even assessments contracted for to support the marketing effort. It can seem terribly attractive to use these, with perhaps an update performed by the original consultant. After all, why spend additional money for work that has already been done once? However, putting aside the potential conflict of interest issues, which may be substantial, an evaluation by another party can identify new issues that may have been missed before. The same set of eyes may very well see the same thing. Potential environmental liabilities do not always come equipped with yellow caution signs, and sometimes they are missed. Tech Print* learned this the hard way when it purchased Integrated Technical Systems (ITS).* Tech Print relied on audits prepared by ITS when it purchased the facility three years before. Their original consultant updated the audit, and both parties were satisfied, that is, until two years later, when the neighboring facility called the fire department about gasoline in its loading bay. Investigation led to an old gasoline tank that no one remembered on the Tech Print property, apparently installed during the oil embargo. The vent pipe could still be seen running up the wall of the building; however, the fill had been blanked off and covered by the paving in the employee parking lot. While there is no guarantee that another consultant would have seen the pipe and tracked down the gasoline tank, the odds could have been shifted more favorably in Tech Print's direction with a second independent evaluator.

FAILING TO EVALUATE CREDENTIALS AND QUALIFICATIONS OF AUDITOR

Frequently purchasers of audit services hire a firm supplying such services without asking about or evaluating the qualifications of the specific individuals who will provide the services. The assumption that all auditors are created

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equal in terms of background, experience, and capabilities is what got Great Lakes Financial* into trouble. That company had confidently extended a loan for the purchase of an industrial complex with apparently no significant environmental liabilities. After all, they had hired a large national consulting firm at an excellent price. The auditor, an environmental scientist five years out of school, had visited the site where he had seen state-of-the-art storage areas, new equipment, and a pristine operation. He wrote a report identifying only minor environmental issues. The Phase I requirement was checked off, and the loan was closed. A short time later, a senior officer at Great Lakes, while reviewing the loan portfolio, became concerned by the fact that the operations, which included plating and metal finishing, dated back to the 1870s. Based on past experience and instinct, he contracted for a second Phase I with another firm. This Phase I was performed by two engineers with more than 40 years' of combined industrial and environmental experience, including experience with similar operations. They uncovered chlorinated organics in the groundwater with the potential to affect drinking water, apparently unpermitted treatment of hazardous wastes potentially subjecting the entire facility to RCRA closure requirements, a potential past septic discharge of industrial wastes, and other less significant issues including PCBs and asbestos. Potential liabilities in the worst-case scenario were estimated to exceed $5,000,000.

FAILURE TO TARGET AUDIT SCOPE TO GREATEST RISK

With the advent of the ASTM Phase I, owners and financial institutions now had a set of requirements against which they could evaluate the thoroughness of the product for which they were contracting. However, the ASTM standard is a one-size-fits-all. Not evaluating its requirements with regard to a company's specific requirements can end up with an otherwise adequate audit that does not focus on the company's risk. Firenzi Wood-Fired Pizzas* was purchasing its competitor, California Pizza.* Firenzi had a 45-day window in which to complete its due diligence on the 150-plus properties, after which it lost the right to make any environmental claims. Since California Pizza leased all its properties and pizza parlor operations were not known for their environmental risk, Firenzi was not too worried about environmental issues; rather, their only concern was meeting their financial institution's requirements. They contracted for standard ASTM audits with a consulting firm. Halfway through the due diligence period Firenzi realized that, while California Pizza leased the properties, they had originally owned the properties and sold them off with a guaranteed lease-back in the early 1980s, mostly to limited partnerships. Suddenly Firenzi realized that they could end up as the deep pockets, if any of the sites had an environmental problem, and it became terribly important to know if a gas station had ever been located on one of their favorite busy intersection locations. Obviously historic use of the property is part of the ASTM audit; however, the standard makes allowance for time and budget constraints. Without identifying past use as a priority, this issue received the same level of attention as all of the other issues raised under an ASTM audit such as the status of air permits for the wood-fired ovens.

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RELYING ON ESTIMATED LIABILITIES WITHOUT CONSIDERING DEGREE OF CERTAINTY

Frequently, consultants are asked to provide estimates of potential remedial costs. If purchasers do not fully discuss with their consultants the repercussions of the uncertainty associated with these numbers on their financial agreements, the results can be very unsatisfactory. Lionhart Ltd.* was busily reinvesting in the United States its gains from divestitures in a less stable country. The dollar was down, and Lionhart could not move quickly enough on all the opportunities it was identifying in such a favorable market. One of its favorites, Merrit Molding,* had five plastics extruding facilities in the south, which would fit well with Lionhart's product mix. Further, Merrit was privately held, and the owners were ready to retire. They had even had environmental audits performed at their facilities to entice potential suitors. Lionhart wisely hired its own consultants, who identified further issues at the facilities and proposed further Phase II field investigation activities to verify and define the extent of the potential issues. Merrit refused to allow this, and Lionhart pursued the acquisition using the liabilities estimated by the consultant. Even with the uncertainty associated with the liabilities, the total liability numbers would have likely covered the combined issues at all the facilities. However, Lionhart negotiated separate escrow numbers for each facility, with any remaining dollars after remediation to be returned to the seller. They

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never discussed the potential impact of this approach with their consultants and, in fact, had not spoken to their consultants since some early questions when they initially received the audit report. One of the more obscure issues raised by Lionhart's consultants regarded possible lead casting activities at one of the facilities. During their site visit the consultants had noticed an old site plan that included a small room labeled "casting." Additionally, in an old aerial photograph in the lobby that appeared to date from the 1940s, they had observed a speckled residue on the roof of the area. The facility personnel claimed that lead casting had never been performed, and the Merrit-generated audits had made no mention of this activity. One year later, Lionhart had confirmed that lead casting operations had occurred and had, in fact, contaminated the interior of the facility. They also found that soil around the building, which received roof runoff, was contaminated, and that during construction of a parking lot some of this soil had been excavated and regraded across the site. Their set-asides for the facility did not come near covering their remediation costs on this issue and additionally, they suffered the further indignity of returning escrow money to the seller for the other four facilities.

FAILURE TO UNDERSTAND LOCAL REQUIREMENTS

Regional, state, and local environmental requirements and programs vary. Not accurately identifying these differences can lead to misunderstandings about potential liabilities. Individual state requirements can have an impact on such determinations as how clean is clean and how much actual investigation is required. A misunderstanding of these requirements also contributed to Capmar's miscalculation of liabilities. Capmar had relied on the financial assurance filings with the state regarding potential liability at the highly contaminated Oxford site. The site was undergoing investigation and remediation under a state-run program. The program required that separate financial assurances be posted during the investigation and the remediation stages. The remediation stage values were to be calculated based on actual anticipated cleanup numbers. However, during the investigation stage, the requirement differed. The state relied on a calculation based primarily on the number and size of hazardous material and waste storage units to determine the required financial assurances. The Oxford site had not yet moved into the cleanup stage; thus, the numbers did not necessarily reflect remediation costs. Not understanding the essential differences between the two stages contributed to Capmar's miscalculation.

FAILURE TO RESPOND TO AUDIT RECOMMENDATIONS

Frequently audit reports raise issues for which further recommendations are made. They may be recommendations for further field investigations, regulatory issues, or even housekeeping changes. Often clients will not follow through on these recommendations. However, because these issues were noticed, they now have an awareness that requires appropriate action. During the audit of LaVerne Party Products,* the consultant noticed suspect asbestos insulation on piping throughout the facility. The material was deteriorated and crumbling at multiple locations. The issue was identified in the report as requiring sampling and compliance with asbestos regulations, if asbestos was present. The facility personnel decided they could contract the sampling more cheaply, and they did. The sampling results came back positive and the report was promptly and efficiently filed, where it remained until complaints from disgruntled personnel resulted in an OSHA audit. After legal negotiations, the facility entered into a consent decree and paid a substantial fine.

GOING WITH THE LOW-COST BID

Many consumers of these types of services consider them a commodity and thus differentiate solely on the basis of cost. They consider the consultant's errors and omissions insurance as their guarantee and may actually see themselves as purchasing insurance rather than services. This approach, however, has certain drawbacks, as Great Lakes Financial can attest to. In going initially with the low-cost bidder, they were guaranteed a relatively inexperienced, low-labor-rate individual. Now, they are faced with a Hobson's choice of taking back the loan and alienating a longtime customer or assuming a level of risk unacceptable to Great Lakes and its regulators. Should the investment go bad and the financial institution have to take back the properties and the significant environmental issues that the customer now owns, it is possible they may have legal recourse against the large consulting firm. However, there is no guarantee that Great Lakes Financial would prevail in court, as

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there is some question as to how forthcoming the facility personnel were on some of the issues. Relying on legal recourse is a chancy, potentially expensive, and time-consuming way to protect assets and customers.

CONFUSING THE VALUE OF AN ASSET WITH THE ENVIRONMENTAL RISK

Often purchasers of relatively inexpensive transfers do not see the benefit of an audit which can be a significant portion of their purchase price. However, environmental risk often bears no relationship to the value of an asset. Mervyn Oddfellow* and several of his dentist associates liked to dabble in real estate from time to time. They located property in bankruptcy at the entrance of a growing regional airport. The property had previously been operated as a gas station. They knew they could rent it out to a budget-type car rental company while the land value would continue upward at this choice location. They thought a bid of $50,000 would be sufficient. Mervyn mentioned his potential acquisition to a patient of his who worked in environmental consulting. His patient strongly recommended that Mervyn consider at least some minimal investigation of the tanks. Mervyn thanked him for his advice but didn't think it was necessary. Mervyn and his partners were extremely disappointed when their bid was second to a mini-mart company which won the bidding. Nine months later, the health department and the state environmental agency were called to the adjacent mobile home park where residents were suffering from a variety of nervous system ailments. Testing of the well water identified extremely high levels of MTBE and benzene. Further, investigation tracked the plume of contamination back to the former gas station property.

FAILURE TO PERFORM AN ENVIRONMENTAL ASSESSMENT

This is probably the potentially most serious pitfall of all, and oddly enough it still happens all too frequently. Sometimes this occurs because the buyer relies on state property transfer laws requiring such things as assessments, disclosures, or a certification of no discharges by the seller. While these would seem to provide protection, this protection can be limited, as Fred Franklin* can attest. Fred, his brother-in-law, and several of their friends, all professionals, got together and purchased a substantial piece of acreage along a scenic river that appeared to be perfect for development into luxury condominiums. They had purchased it at an irresistible price and knew they could turn it over quickly for a substantial return. Although a former thermometer manufacturer had been located on the property, the property had passed through the state property transfer process without any problems. Fred and his partners elected not to perform an independent assessment. They held the property for two years, a longer period than they had originally intended, until they found a developer who was interested. The transaction was structured so that Fred and his partners would share in the proceeds from the development and the additional gains from this would more than make up for the financial ground they had lost during the slow turnaround. Prior to signing the agreement, the developer's financial backers required an environmental assessment. The consultants hired to perform the service found

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broken thermometers and suggested a Phase II assessment. Samples identified mercury and other toxic metals in the soil. The developer backed out of the deal and Fred and his partners initiated suit against the former owners. Two years later a plan was negotiated with the former owners to clean up the site. Fred and his partners are still paying property taxes, do not yet have a piece of property they can develop, and the original developer has started selling condominiums at his new luxury development two towns away.

CONCLUSION

How then can you avoid these common but potentially expensive pitfalls? The answer starts with planning. Don't think of the environmental assessment as an add-on, contracted for at the last minute. Include this issue early on in the development of a project just as you would develop financing or analyze the business potential. Planning in the beginning can result in a product which meets your needs.

Identify your needs early in the planning stage. Consider such things as what you will be using the audit for and what information you require. Give careful consideration to identifying and weighing your potential risks in determining your needs. Develop the potential consequences and their likelihood of occurring. In this way you can better evaluate the scope of your audit. As examples, are you considering an acquisition with current operations that could have potential environmental impacts, or is

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current use not a concern? Then, perhaps past use will be your focus. Are you purchasing the business or just the assets? If it is the business, possible offsite disposal in addition to onsite operations may be your concern. From a business perspective, who will retain the liability, or will it be split? Are the assets of those retaining the liability sufficient to cover the potential cost, or are they limited, and could this potentially affect you? Questions such as these will help you sort out risk factors and define an appropriate scope.

After you have completed this assessment, design your assessment program so that it focuses on your most significant risk factors. For example, if you are purchasing a facility out of bankruptcy, it may not make sense to concentrate on offsite issues. However, it might make sense to develop a combined, targeted Phase I and Phase II assessment of the property. At this point, you may want to consider using the design of your program as a criteria to select the appropriate consultants. An RFP that asks for an approach rather than a bid on a scope will provide you with good insight into the compatibility of the consultants' approach and your needs. Do not do this, however, unless you have done some evaluation of your risks. Otherwise, you will not be able to sort effectively between the options.

Match your requirements to the capabilities and experience of the auditor. Has your acquisition had a past or present industrial use? If so, consider the experience of the auditor at these types of operations. Does he or she know past practices? Does he or she have a knowledge of hazardous materials and their past and present use? If, on the other hand, you have a large commercial transfer, use someone with this type of experience. Also insure that the individual you have selected is familiar with your locations and local and state requirements.

Do not forget your business requirements in assessing the capabilities of your chosen auditor. Do you require support with the financing institution? Then select someone who has the expertise to provide an appropriate level of comfort to both you and your financing institution. Are you going to structure a set-aside for escrow account? Are the buyer and seller going to share in the costs? If so, then find someone who can understand these types of financial arrangements and assist you in assessing the potential outcomes. Also, consider the overall level of risk you have identified. If this requires an individual with extensive experience and capabilities, then expend the resources necessary. If this is not the case, then the lowest cost approach may be appropriate for you.

Rely on independent assessments. Whether it is an assessment of the environment condition of the property or an estimation of potential liability, the benefits of the independent view can not be overemphasized. If you choose not to do this, be sure you have carefully considered your potential risk. If other consultants have worked at the site and you are relying on information provided by them, involve your consultants in questioning them about their findings and underlying assumptions. And, finally, although this is added by the writer with great trepidation lest it be seen as extremely self-serving, consider the benefits of moving toward more of a partnering relationship with your consultant. This would include such things as involving the consultant early in the planning and throughout the entire process. His or her input in identifying potential risks, targeting the audit toward these concerns, and working through liability issues could actually provide greater value for the dollars spent. This type of structure requires an extensive and ongoing transfer of information of both a technical and business nature between the parties to be successful. It also requires far more of the consultant who must move out of a strictly technical role and fully understand and act on the overall goals and needs of the client. However, in the long run, a relationship of this type can better serve both parties and ensure that the product and services provided by the consultant provide real value to the client. ■

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