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Transitioning from Environmental Due Diligence to Auditing

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Although environmental due diligence can be critical to the valuation of an asset prior to purchase, following purchase, compliance is of paramount concern. A new owner must quickly transition from viewing operations from the perspective of a buyer trying to value a purchase appropriately to viewing operations from the perspective of an owner trying to achieve compliance with an operating budget. This transition may also involve developing an intimate familiarity with the assets just purchased—a familiarity with the assets typically unique to an owner who has unbridled access to the facility and its records not available to a prospective buyer. Ongoing compliance issues may have been identified during due diligence and the lack of a new owner's comprehensive knowledge of the facility's compliance status creates a substantial risk. Because both federal and state environmental regulatory agencies offer various incentives to mitigate the risk of assessment of enforcement penalties and because audits can quickly build a new owner's knowledge base regarding the assets' compliance, an audit is an excellent tool to manage this risk during the transaction and beyond and, ultimately, increase value following closing. Further, if extensive due diligence prior to the transaction was not conducted, environmental risk acquired through the transaction can still be identified and managed by self-assessing or auditing.

In the environmental context, an audit is a systematic evaluation of a facility or operation during a defined period of time (a "snapshot in time") to determine compliance with environmental laws or to identify issues that could give rise to compliance issues. Compliance management practices are also frequently reviewed during an audit. The scope of an audit can be comprehensive, similar to due diligence, or it can be targeted to address specific areas. For example, compliance with an air permit may be of paramount concern and, thus, the limited subject of an audit.

At the federal level, the U.S. Environmental Protection Agency's ("EPA") New Owner Self-Audit Policy encourages participation in the voluntary self-policing and disclosure process by buyers who find compliance problems during due diligence and then become owners.[1] EPA also offers additional penalty mitigation incentives to new owners, who within the first nine months after acquisition, examine facility operations, voluntarily disclose violations identified, correct violations, and upgrade deficient equipment and compliance practices.[2]

In Texas, audits and the associated protections are defined by statute rather than policy. Texas law is prescriptive and, until September 1, 2013, did not afford immunity to a prospective purchaser who discovered a violation during due diligence, became the owner, and wished to address the issue after closing. New owners were not able to plug themselves into the protections of the Texas statute in the same manner allowed by EPA's New Owner Self-Audit Policy due to criteria, such as prior notice of the audit, prescribed by the Texas statute.

Senate Bill 1300 (83rd Leg., R.S. (2013)) amended the Texas Environmental, Health, and Safety Audit Privilege Act ("Texas Audit Act") and accomplished the following:

- Recognizes that due diligence conducted prior to acquisition is an audit.[3]
- Eliminates the need for the notice of audit to be given in advance of that diligence in order to qualify for immunity.[4] This makes sense as sellers are naturally reluctant to allow the buyer to give notice to the agency that a comprehensive audit or any level of audit is being conducted before the buyer is actually the owner.
- Allows the new owner to obtain immunity for discoveries made during diligence and then disclosed within 45 days after closing.[5] This is consistent with EPA's New Owner Self-Audit Policy with respect to such discoveries and disclosures. By giving notice within 45 days after closing, a new owner can also enter the audit program and continue an audit that actually began as due diligence but that would benefit from a more in-depth evaluation that only an owner (as opposed to a prospective purchaser) with full access to the facility and relevant compliance records can obtain. The audit can then continue for up to six months from the closing date.[6]

There are numerous areas where EPA jurisdiction overlaps with state agency jurisdiction. Air and water permitting and waste management are examples. These overlaps create situations in which one must consider disclosing both to EPA and to the state. The new amendments to the Texas Audit Act eliminate the conundrum that existed when the federal policy afforded greater protection than the state program. The legislation allows the state to approach the issue in a manner consistent with EPA's approach. The amendments also eliminate the situation in which the opportunity to disclose and fix is rejected because of the perceived risk of penalties on the state side.

Auditing and voluntary disclosures to EPA and state agencies have been effective tools for oil and gas companies that are trying to manage the risk of environmental enforcement while trying to comply with new regulatory requirements—such as greenhouse gas reporting and requirements under New Source Performance Standards Subpart OOOO—that have recently been imposed on the industry. Auditing and voluntarily disclosing identified violations can also be effective compliance tools for new owners who discover that the prior owners have not been complying with such recently-promulgated requirements, compliance with which can be very resource-intensive, time-intensive, and people-intensive. A seller may not be willing to invest such resources in assets that the seller plans to flip. The new owner can manage the risk of enforcement following closing of a transaction by notifying EPA and appropriate state agencies and proceeding to fix the problem. These proactive measures by new owners also have the benefit of providing EPA and/or Texas environmental regulatory agencies assurance that compliance issues that would not otherwise be identified are corrected, resulting in improved protection of human health and the environment.

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[1] Interim Approach to Applying the Audit Policy to New Owners, 73 Fed. Reg. 44,991, 44,993 (Aug. 1, 2008), available at http://www.gpo.gov/fdsys/pkg/FR-2008-08-01/pdf/E8-17715.pdf.

[2] *Id.* at 44,998.

[3] TEX. REV. CIV. STAT. ANN. art. 4447cc, § 3(a)(4) (West 2014).

[4] *Id.* § 10(g).

[5] *Id.* § 10(b)(1)(B).

[6] *Id.* § (4)(e)(2).

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