MEASURING THE RISK: GETTING IT RIGHT

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I. INTRODUCTION

Contaminated site liabilities are often unforeseen. The instinct to share the misery is sometimes difficult to resist. Disputes concerning contaminated lands include disputes between:

a. vendors and purchasers, landlords and tenants, and lenders and borrowers over who should be responsible for clean-up;

b. government and potentially responsible persons over allocation of liability and standards of remediation;

c. adjoining landowners over migrated contamination; and

d. insureds and insurers over coverage for environmental events.

Needless to say, it is much preferable to identify and plan for contaminated site liabilities. In order to identify and appropriately value environmental risks or liabilities, it is essential to know what to look for and to understand what it is that you may have found, and, indeed, to understand what it is that you may not have found.

The art of the deal is the "Goldilocks" approach to environmental risk: neither over-react nor under-react to risk. It is useful to have in mind that whomever is taking on risk likely will receive compensation in the deal and whomever is being protected from risk likely will be required to pay compensation.

II. DUE DILIGENCE

As you will be aware, due diligence is used at least two ways in the environmental law context. The first is as a defence to a regulatory offence. As was set out by the Supreme Court of Canada in *R. v. Sault Ste. Marie*, no one can be convicted of an environmental offence if that person exercised due diligence or all reasonable care to avoid the commission of that offence.

The second involves a systematic review of a target business to identify and assess strengths and weaknesses – in particular to identify and value risks attendant with the transaction.

Applying the regulatory definition to the transactional application of due diligence, it might be said that transactional due diligence involves exercising all reasonable care to avoid buying more than you bargain for. It is a balance between rigour and practicality.

It is important at the outset to identify goals. What is the threshold level of risk which the particular due diligence process is intended to uncover? The nature of environmental due diligence depends upon the risk parameters set and the nature of assets to be acquired. In order to discover and value particular risks or liabilities, it is essential to know what to look for and to understand what it is

that you may have found. It is also important, as has been made famous by Donald Rumsfeld, to identify and value what may not be found in the due diligence process (known unknowns).

III. SCOPING THE RISK: DON'T BUY MORE THAN YOU BARGAIN FOR

A. Identifying Risk

In situations where there are environmental reports, the starting point for identification of risks will arise from those reports. The environmental report should consider historical uses of the property, and of surrounding properties, so as to make it more likely that contamination issues, if present, are accurately identified. Most environmental reports (other than remediation plans) will not address remediation costs in a rigorous fashion. As such, it will be necessary to try and pry out as precise a remediation estimate from the environmental consultant as is practicable. As part of that process, it is important to establish the level of confidence associated with the estimate, given that in many circumstances the extent of the contamination will not be completely defined. A remediation process sometimes bears a disconcerting resemblance to a home renovation. You don't really know what is behind that wall until the wall is removed.

It is also important to be mindful that remediation is not necessarily a time limited process and may not simply be dig, remove and be done with it. Remediation may require long term involvement in a site or reinvolvement if regulatory standards change or further contamination is found.

There are two types of risks that are at the centre of concern with respect to remediation of contaminated lands. The first type of risk relates to the costs of remediation. If a purchaser of contaminated property is going to have to remediate contamination in order to develop the property, that risk is a cleanup cost risk. The second type of risk, which is an oversimplification of a complicated area, relates to liability to others. That liability risk falls within a range of responsible persons and a continuum of factors going to the allocation of responsibility among responsible persons. A vendor of contaminated property should take into account not only the risks related to costs of remediation but liability risks, including how the vendor qualifies as a responsible person and evaluating the allocation of responsibility between other responsible persons.

B. Valuing Risk

Valuing risk, needless to say, is a subjective matter which is driven by knowledge gained from your environmental consultants and by your client's appetite for risk. For the most part, what is being valued is the potential that money will have to be paid in the future for clean-up costs. Paying for risk, or more properly said, paying to avoid potential risks, might be seen as crystallizing the risk. Put another way, what is your client prepared to pay now in order to avoid a potential for paying in the future? Seen in that light, clients with a high risk tolerance may be prepared to pay little unless there is the real potential for catastrophic risk.

The other driver in valuing risk is the deal itself. An anxious seller or a motivated buyer may be willing to pay more to avoid risk, or take on more risk, in order to get the deal.

Finally, there are two analytical constructs which are useful in valuing risk. The first involves setting out a continuum of possible costs which may be incurred with respect to known contamination with the continuum taking into account the range of possible costs and the likelihood of those costs being incurred. The second involves conceptualizing a separate continuum of possible costs with respect to unknown contamination which, given the nature of use of the property, may be present.

C. Allocating Risk

There are a myriad of methods of structuring transactions which involve contaminated sites, each of which involves an allocation of environmental risk and liability between the parties. The various alternatives usually include one or more of the following aspects:

- a reduced price (to take into account estimated remediation costs, the uncertainty over the actual costs, or residual stigma);
- a commitment by one party to remediate the contamination; and
- an express allocation of environmental risk and an indemnity.

Questions which must be addressed where one party agrees to remediate include:

- to what standard should the contamination be remediated and what will be the independent verification?
- should the other party have any right to influence or review the remediation approach?
- should there be security for the remediating party's obligations (i.e. a holdback, mortgage, or letter of credit)?

Words matter. The language of the covenants and indemnities may someday be tested. Clarity is essential. Having said that, a promise to indemnify (i.e. an indemnity agreement) is just that, a promise: a promise which may or may not be kept depending in part on available financial resources. While words are important, the best route to clarity is to first define the business theory of the allocation. Think through how various scenarios might play out. Once the theory of the deal is settled, the words must clearly express the theory and cover unintended consequences. Some particular questions to be addressed include the following:

- who will bear the risk of known contamination existing on-site?

- who will bear the risk of contamination coming onto the site from a neighbouring property and the risk of contamination leaving the site onto a neighbouring property?

- who will bear the risk of contamination unknown at the time of sale or contamination which did not offend government standards and criteria at the time of sale but subsequently offends those standards as a result of the adoption of new criteria?

As can be seen from the above, the term "allocation" is more expansive in meaning than just assigning percentage responsibility for clean-up costs between the parties. It addresses the nature of the responsibility taken on by a party and which party will bear that responsibility. There are essentially four allocation structures.

The first involves one of the parties taking on responsibility for remediating the site. This structure must be viewed with great care by the person taking on that responsibility. A contractual responsibility to remediate can be an onerous and open-ended obligation and may require co-operation particularly with respect to an operating site.

The second structure is where one party indemnifies the other party for a specified or open-ended future clean-up costs responsibility. Defining the event and the trigger should be set out with as much precision as possible.

The third structure is where the purchaser takes on the property "as is where is" and releases the vendor from responsibility for clean-up. Without an indemnity, this is of limited value to the vendor given that the vendor's liability might continue in the event of a sale or a regulatory clean-up order.

The fourth structure is one in which the parties actually allocate responsibility to divide the potential cost of remediation. Issues that arise under this scenario include the trigger to the obligation to remediate, standard of remediation and who will have conduct of the remediation.

It is important to first think through the theory of the deal and to settle the business terms of the deal. Once that is accomplished, then the words of the agreement must clearly express the theory of the deal and cover unintended consequences. Again, words matter. The language of the covenants and indemnities may well be some day tested.

V. CONCLUSION

Ensuring that you do not buy more than you bargained for is a process of:

- identifying and measuring environmental risk at the outset – the more you know about the site at the outset, the better you will be able to navigate and negotiate through the risk minefield;

- neither over-react nor under-react to the potential for environmental risk; and

- Lastly, properly "papering" the transaction so that the essential deal is properly addressed and so that nuances and unanticipated outcomes are thought through.