Environmental Due Diligence

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Over the last few years, due diligence has become increasingly important in national and international transactions. In particular, there has been an increasing number of foreign investors, often from the US, who are interested in doing business in Europe. For this reason the demand for experts able to provide a due diligence has been growing in Europe. While corporate and tax law have so far been the main focus of the diligence procedures carried out within the framework of a transaction, it has also, in the meantime, come to be generally acknowledged that environmental issues and risks under environmental law can be decisive to the success or failure of a transaction. This article intends to describe the functions of an environmental due diligence in more detail, and to explain how the results can be appropriately taken into account when drafting an agreement. The following comments are based on German law, though they are similarly applicable in most other European jurisdictions.

I. Introduction

The most appropriate explanation of the term due diligence is to describe it as an audit and assessment of an enterprise. The subject matter of a due diligence is an examination of a certain object of purchase, normally an enterprise or real estate, in terms of its potential legal or economic risks. While other kinds of due diligence are primarily focused on the examination and assessment of the object of purchase with regard to aspects of corporate, labour and tax law, the environmental due diligence is concerned with the establishment and evaluation of potential risks under environmental law. In addition to issues regarding environmental organisation, issues such as site contamination, licenses under environmental law, legal disputes over administrative procedures or before administrative courts and the costs of environmental protection associated with the target enterprise are the main concerns. Since possible risks in this context, such as the risk of cost intensive clean up or the risk of a shutdown due to a lack of licenses, can be of decisive importance for the intended transaction, it is necessary to establish and evaluate such potential risks, where possible, before entering into contract negotiations in concrete terms or, at the latest, prior to the conclusion of an agreement.

II. Functions of the due diligence

As mentioned above, the main function of the environmental due diligence process is to establish the environmental risks in connection with the respective object of purchase. By using the results and evaluation of environmentally relevant information, the purchaser is able to assess whether or not the acquisition of the object of purchase carries any special risks. At the same time, the due diligence process also makes it possible to appraise the value of the object of purchase as precisely as possible. Pending remedial action or investment in necessary changes – for example upgrading facilities in order to comply with emission control laws in accordance with license requirements – can be of major importance in determining the value of an enterprise and thus its purchase price. Consideration of such facts gives the potential purchaser relevant information about the risks and value of the target company or business, which can then form the basis for further decisions taken by the purchaser. Thus, a potential purchaser may either decide, on the basis of the established risks, not to acquire the target at all or – if and to the extent that it is possible – to acquire only a part of an enterprise. Within the framework of continued contract negotiations, the purchaser may be able to work towards a reduction of the purchase price at an early stage. Finally, the due diligence contributes to the subsequent wording of the sale and purchase agreement. Thus, the results and evaluations of the environmental due diligence are

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2 See Fleischer/Körber, BB 2001, p. 841 (842).
also taken into account in the course of the negotiations and in the drafting of individual clauses of the agreement.

III. Due diligence check list

The basis for and the most important aspect of a successful environmental due diligence is the preparation of a due diligence check list. With the help of such a check list, the current environmental situation and any related risks can be comprehensively established and properly evaluated. In this respect, not only the (financial) risks of contaminated sites are important. The situation under environmental license law is also of importance in many cases, particularly when a manufacturing enterprise is the target of the intended acquisition. If, for example, licenses required under emission control law have not been obtained, or if the production facilities are not operated in accordance with those licenses already granted to the facilities, the closure of the enterprise and subsequent loss of production could be a serious possibility. Unforeseen risks in terms of environmental law may also have consequences under criminal law. If production facilities are being operated without the required licenses, or if the operation does not comply with the respective licenses, or if contamination of the air, soil or water occurs, the purchaser as the (new) operator of the facilities can also be called to account under criminal law.

In the framework of an acquisition of real estate or a business, the companies that are active on the seller's side are often not in a position to establish the current environmental situation themselves or to present the information to the purchaser in a comprehensible way. A check list is therefore necessary to ascertain, structure and evaluate the actual facts under environmental law. Such a check list should not be prepared in a standard form or applied schematically. When preparing the check list, the kind of business concerned and any special features – for example the type of production and substances used in the process – must be taken into account individually.

Depending on the individual circumstances of the acquisition and the acquisition target, the following may feature as items on an environmental check list:
- general information on the company and its permanent establishments
- the company's licensing and audit status under environmental law
- insurance coverage concerning environmental issues
- the environmental organisation of the company
- the situation of the company's real estate under environmental law
- the situation of the company's real estate under building law
- any substances harmful to water
- fire protection
- licenses under law concerning water
- handling of waste water and waste
- soil and ground water (contaminated sites)
- health and safety

Considering the large number of potential risk factors, there is a danger of overwhelming the seller with a too detailed and comprehensive check list. On the one hand, if a check list contains several hundred questions, it is possible that they will only be answered superficially or that certain parts of them will be ignored, especially, if such a check list has also to be sent to a company's foreign locations. On the other hand, a check list that is too brief carries the danger that potential risks remain entirely undiscovered until after the conclusion of the sale and purchase agreement. A happy medium must therefore be found, taking the facts of each individual case into account. Ideally, the target company should be confronted with questions concerning relevant topics, so that the answers are actually relevant for the assessment of the risks.

It may be helpful to look in more detail at some items of particular importance:

1. Soil and ground water

As a general rule, one element of an environmental check list should be questions concerning the possible contamination of the soil and ground water. Especially in the case of long standing production sites, this is always an area of potential risk and it can be of importance in determining the

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