Bowles Rice
ATTORNEYS AT LAW

Environmental Due Diligence in Coal Transactions

And

An Update On Recent Environmental Cases

Prepared by

Leonard Knee, Esquire

lknee@bowlesrice.com

(304) 347-1726

www.bowlesrice.com

Environmental Due Diligence In Coal Transactions

I. Introduction

A coal transaction typically involves several different kinds of facilities. These include such things as: preparation plants, refuse and slurry disposal areas, deep mines, surface mines, loading facilities (truck, rail, and barge), haul roads, transmission lines, water lines, and easements of various sorts. The property holdings can be extensive and complex. Where the properties have a long history of mining historic or legacy issues are usually present.

In the modern environmental world these facilities require a variety of permits, and present a variety of environmental impacts. Understanding the permitting and the environmental impacts is essential to a successful transaction. Frequently, the environmental issues are a major part of the transaction. Addressing these issues can be intricate and time-consuming. It is critically important to avoid surprise. A professional due diligence is a necessity.

A law firm's role in an environmental due diligence can be complex. Typically an environmental due diligence is only part of the law firm's role in the transaction. Law firms are usually engaged to do the transaction work, the title work, and assist with or prepare the environmental due diligence. Often more than one law firm is involved. For example, a separate law firm can do the transaction work.

An environmental due diligence is principally undertaken to address liability concerns. In addition, it can address compliance with current permits, and the permitting necessary to do future projects. An environmental due diligence allows a quantification of the liabilities, the potential risk, and an assessment of methods for dealing with these issues.

Depending upon the size of the transaction, an environmental due diligence can be relatively simple or exceedingly complicated. Doing an environmental due diligence requires assembling a knowledgeable team - experience counts. A knowledgeable team can expedite the assessment and determine where to focus resources. Experienced group allows efficient allocation of tasks among team members. It also allows movement of work between personnel and circumstances dictate.

The time frame available for the assessment is critical. The time available determines the depth and scope of the due diligence. Advanced planning is a necessary element to a successful due diligence. The critical path, particularly with regard to obtaining information, must be decided early.

In order for the work product to be of value, there must be an upfront agreement about its scope. Careful attention to the scope of the due diligence is essential.

II. The Beginning

A variety of agreements typically need to be done. These include: (1) the engagement letter between the client and the law firm; (2) an engagement letter between the client, or the law firm, and the environmental consultant or consultants; (3) access agreements allowing environmental consultants to enter onto the property or properties and conduct the investigation. Other agreements may also be needed.

A. The Engagement Letter

The engagement letter should describe all of the work that is going to be done. Typically title work and transaction work will be done in addition to environmental due diligence. The engagement letter can be used to describe the scope of the environmental due diligence. This is usually not a good idea. It may delay signing the engagement letter, as the scope of the due diligence frequently requires significant dialogue. Typically, a law firm will want to get the engagement letter in place before it

begins significant amounts of work under the project. An important point within the engagement letter is to identify the principle lawyer responsible for the project at the law firm.

The engagement letter should identify each element of the work to be done by the law firm: transaction, title, due diligence etc. It should also identify who within the law firm will be the principal contact for each element. The engagement letter should also describe any areas, which the law firm is not being engaged to address.

B. Engagement of Outside Consultants

Outside consultants are a necessary part of an environmental due diligence. Usually they will be the lead on the due diligence. The first question regarding outside consultants is who will engage them - the law firm or the client? The second question is whether there is a need to try to cover the work of the outside consultants through the attorney-client privilege-attorney work product doctrine.

Obviously if there is a desire to try to protect the consultants work with the attorney-client privilege-attorney work product doctrine, then engagement by the law firm is necessary. Who will be the ultimate user of the work product is a critical question. If the work product is to be distributed to third parties, then engagement by the law firm may not be desirable. Additionally, if the law firm engages the outside consultants timely payment of them must be arranged with the client.

The consultant engagement letter presumes an understanding of the work by the outside consultant, the timeframe of the work, and the work product. Drafting the consultant engagement letter requires that the scope of work be known. Typically the allocation of the work is discussed by the client, the law firm, and the outside consultants. The deciding elements in work allocation are usually cost-effectiveness, and timeframe. If the outside consultants work product is to be reviewed by the law firm, as is typically the case, the timeframe needs to be adjusted to allow this to occur.

Occasionally there may be issues about “battle of forms”. Outside consultants typically have their own engagement agreements. They should be carefully reviewed particularly with regard to liability limitations. Usually satisfactory agreements can be negotiated.

An often overlooked or under appreciated issue is the amount of professional liability insurance for the consultant. The buyer needs to have a clear understanding of the insurance and any exclusions. Usually the amount of insurance and the exclusions can be negotiated.

C. Access Agreements

Outside consultants will almost certainly need access to the properties. Occasionally, the law firm may need access to the properties. The access agreements may be two-way that is between the seller and the outside consultant, or three-way between the seller, the buyer, and the outside consultant. Access agreements are generally readily available.

Access agreements have to be in place before the properties can be visited. Also important, is whether intrusive sampling is going to be done. Air, water, and soil samples may require doing split samples with the seller. The seller may also require copies of all sample results and all expert reports. This increases costs, and potentially adds delay.

D. Confidentiality Agreements

A confidentiality agreements may be sought by the seller. Such agreements may be insisted upon when the buyer wants to take environmental samples. Two points frequently emerge. Does the seller want to know the results? If a violation is found is there an obligation to report it to the regulators? Who will make the report? These points often require considerable negotiation. This slows down the due diligence.

E. Assembling the Team.

The size and composition of the team depends upon the number and the nature of the facilities to be investigated. The larger the project and the more varied the facilities, the larger and more diverse the team. The due diligence team typically includes one or more in-house counsel, one or more in-house environmental professionals and/or engineers, outside counsel, and the outside environmental consultant[s].

Experience counts. Coal mining is a unique. Many issues associated with coal mining have to be experienced firsthand. Careful selection of the team is required. A good solid team will avoid problems and produce a professional work product

In-house counsel must have a clear understanding of what they want accomplished. What is the work product to be produced? When is it to be produced? What is the estimated budget? Who is in charge of the individual pieces? What are the limitations? What are management's expectations?

In-house environmental professionals and/or engineers are equally important. Are their expectations the same as in-house counsel's? They typically will already have done some level of review. What are their initial impressions? Have they identified particular areas of concern? Have they established priorities? What parts of the due diligence can be done by them or their staffs? Do they want or need access to the properties? If so the access agreements need to allow this.

The lead outside counsel's job is management. Outside counsel and in-house counsel need to set the scope of the work, the allocation of the work, the timeframe of the work, the work product to be delivered, and the timeframe of delivery decided as early as possible. Outside counsel must be extremely conscious of time frames.

Typically outside counsel will review the outside consultants work to identify issues and concerns. That requires receiving the outside consultants work product early enough to do this. Equally, will there be separate reports from outside counsel and the outside consultants?

The outside consultant[s] often has the laboring oar. They need to be involved in establishing what should be done, what can be done, and the time frames. It is important to make sure that the outside consultant or consultants have the right expertise to address the anticipated areas of concern. Is there a need for engineers with experience in dam safety? Is there a need for consultants with experience in wetlands? Is there a need for consultants with experience in endangered species? Adding additional specialized outside consultants can create time problems in doing the work.

Organization of the teams requires communication. A list should be prepared that identifies each team member, their contact information, the organization that they are with, and the areas that they are responsible for. That list should be circulated to everyone involved in the project.

To the extent practical there should be conference calls as necessary to coordinate the work and monitor progress. Conference calls should be scheduled at a specific repetitive time i.e., Tuesdays at 9 AM. Conference calls should preferably be run by outside counsel. Usually in-house counsel gets swamped by a variety of issues related to the transaction. Outside counsel should insist that they start on time.

An experienced well-managed team is a necessity. It will avoid all kinds of problems, and produce a high quality work product on time.

F. The Time Frame

There is never enough time. Time is an implacable enemy. To create a time frame start with the deliverable due date and work backwards. You will be shocked at the result. The elements are: (1) the deliverable due date, (2) writing the report[s], (3)

analyzing the data, (4) obtaining the data, (5) allocating the work among the team (6) assembling the team, (7) deciding the scope of work, (8) producing and signing initial agreements, and (9) engaging counsel.

There are several elements over which there is at best limited control. Due diligence typically requires Freedom of Information Act (FOIA) request to a multitude of agencies. These agencies have different response times, different amounts of online information, and different quality control.

If sampling is necessary the amount of time to do it, get the results, incorporate the results into the analysis has to be carefully considered. Expedited laboratory work can be very costly. This is a place potentially of major problems.

Frequently team members use other team member products as input for their work. Delays can have a cascade effect. Internal deadlines have to be established and ruthlessly adhered to. Outside counsel, or the overall project manager, must be especially sensitive to this point.

Once the scope of the work has been laid out, establishing the timeframe will often show that the scope of the work is unrealistic given the timeframe available. This in turn will require revising the scope of the work and establishing priorities.

G. Budgets

Typically a client will desire a budget. Preparing a budget requires knowing the scope of the due diligence. It also requires knowing the assignment of the work between in house personnel, outside counsel and outside environmental consultants. Once these elements are known, a budget can be prepared. One of the items that can be hard to estimate is the expenses that might be incurred. In particular, the outside consultant[s] should be required to prepare a budget as well as the law firm.

Budget categories include: assembling the information to review [this is often done by or in coordination with outside consultants], reviewing the information and

identifying specific issues, addressing the specific issues, preparing the report, and discussing the report findings with the client. Provision needs to be made for conference calls, draft report, revisions, and production of the final product.

Perhaps the most effective way to prepare a budget is to estimate the amount of time that each team member is likely to spend doing his or her piece. This can then be readily summed up into a budget. Allowance for the unexpected should also be included.

H. Format

The format of the final report should be decided early. If a large number of facilities are reviewed, the reporting format should be designed so that people reviewing different facilities can use the same format to report their results. This will make assembling the final report easier. The format should be agreed to by the client and reviewed by any outside parties who will participate.

The format of the report should include: (1) the scope of the work performed, (2) an executive summary, (3) whether the report is attorney-client privileged-attorney work product, (4) the limitations of the report, and (5) the substantive analysis and conclusions.

The limitations of the report might include such things as: (1) availability and accuracy of information, (2) the scope of the work performed, (3) that the report is not an engineering opinion, (4) the things not done and not considered, (5) that the due diligence ended at a specific time, and (6) that the report is not a guarantee. Each situation will have its own specific limits.

The time when the due diligence ended is important. Frequently, electronic data rooms will be continually updated. There often updated after the environmental due diligence has ended. Including a specific time when the due

diligence ended prevents confusion about what was considered, and potentially minimizes liability risk to the lawyers and consultants doing the due diligence.

Lawyers want to make certain that to the extent that environmental consultants and/or engineers have expressed opinions the lawyers are not verifying or adopting those opinions.

III. Reasons For Doing the Due Diligence

There are a variety of reasons for doing an environmental due diligence. A key one is that the lender for the transaction will require one. Lenders want to be assured that the collateral, real estate for example, will not be compromised by environmental concerns. They are also concerned that environmental issues will affect cash flow and make repayment difficult.

Lenders vary in their sophistication about a due diligence. Many have in house personnel who review the due diligence. These persons vary from highly knowledgeable to useless. It is important to have an early conversation with them. The due diligence must be satisfactory to the lender. Getting an understanding of experience and expectations of the lender's team is critical.

Equally, lenders may have a "standard approach" to environmental due diligence. If so this will have to be taken into account. Lender's "forms" will have to be considered in order for the due diligence to be successful.

Buyers want to know the potential environmental risks associated with an acquisition. This allows them to address these risks with the seller. Indemnities, representations and warranties, reduction in the purchase price, and escrow accounts, can often be negotiated to address environmental issues. But the buyer must know about them. Equally the buyer must have some idea about a dollar amount associated with the particular issue.

IV. The Scope

The scope of an environmental due diligence is the critical document. It is the agreement between the client and the law firm about exactly what will be done. The scope determines everything else. Determining the scope is a function of the desired product, the available time and resources.

There is no particular definition of environmental due diligence. It means different things in different circumstances. The scope must define the due diligence. Who will use the report and what will they use it for are critical questions. Different audiences have different needs. This point needs to be clearly understood in the beginning.

Is this a fatal flaw analysis? Is this the identification of "recognized environmental conditions"? Or a determination of environmental compliance with permits and regulations? Determination of whether all permits necessary for the operations have been obtained? Is there a need to anticipate whether new or modified permits will be needed for future operations? Are potential emerging environmental issues to be identified?

A fatal flaw analysis is materially different than a traditional environmental due diligence. As a generalization a fatal flaw analysis focuses on identifying matters of such magnitude as to negate or substantially diminish the benefit of the acquisition. A fatal flaw analysis will typically focus on non-routine matters the occurrence of which would make the acquisition undesirable.

A fatal flaw analysis will take into consideration the magnitude of the acquisition. It will focus priority and resources on dams and impoundments, deep mines inundated with water with the potential for breakouts, long-term water treatment, landfills, and refuse area stability. It likely will exclude some matters from consideration altogether. These might include haul roads, transmission lines, mine reclamation costs [dirt moving]. These areas are much less likely to generate large-scale problems.

Environmental due diligence is typically thought of as a phase I. A phase I considers recognized environmental conditions. The American Society for Testing and Materials in E1527-13 defines a recognized environmental condition as “the presence or likely presence of any hazardous substances or petroleum products in, on, or at a property: (1) due to release to the environment; (2) under conditions indicative of a released to the environment; or (3) under conditions that pose a material threat of a future release to the environment. De minimis conditions are not recognized environmental conditions.”

This definition is not particularly useful for mining operations. The complexity of mining operations, the potential for problems, and the limitations of the definition make its use problematic. Nonetheless, a reasonable environmental due diligence often will cover much the same ground as a phase I.

The time frame available for the due diligence will play a decisive role in deciding the scope. The more time available the more thorough the due diligence. A second critical element is the amount of information available from the potential seller. It is very important how that information is presented and organized. Good information well organized is very important. Bad information badly organized can cause all kinds of problems.

What is not going to be done needs to be decided. Examples of this might include: MSHA, zoning, asbestos, lead based paint, and agreements not to conduct certain kinds of mining. Priorities might lead to certain kinds of issues not being considered at all.

The scope of the environmental due diligence needs to be memorialized in some fashion. This needs to be a writing - whether a letter, memorandum or email is not critical. That there be a writing is. There should be an explicit agreement about the scope.

V. Sources of Information

There are potentially several sources of information: the seller, the buyer, federal and state agencies, the internet, and specialized publications. Each has advantages and limitations.

A. Seller

The seller should be expected to provide: facility names, permit and id numbers, internal environmental compliance reports, outside consultant environmental reports, seller proposed capital budgets, phase I and phase II site assessments, transaction attachments (usually in draft form), litigation and agency enforcement actions (NOVs and COs).

Typically this information is provided in an electronic data room. This is highly desirable. It will be necessary to spend some time rummaging around to see what the organization is, what is present and what is missing. Data rooms will be updated periodically. This causes problems, but cannot be avoided.

Electronic databases provided by the seller are frequently inadequate, updated sporadically, and subject to mistakes. Dialogue with the seller to provide additional information can be frustrating. These issues need to be brought to the attention of in-house counsel as quickly as possible. In-house counsel may well have to elevate these issues to the deal level to get enough traction to get these problems addressed.

Paper data rooms still occur and can be exquisitely problematic. They require sending a team to a location or locations, and it can be difficult to obtain necessary copies for analysis or use. If at all possible they should be avoided like the plague. They can turn an otherwise manageable project into a quagmire.

The seller should be expected to answer questions. These may be directed to particular representatives of seller. All contact between buyer and seller

should go through or at least involve buyer's in-house counsel. Outside counsel may not be aware of transaction dynamics that inquiries could affect.

B. Buyer

Typically buyer will have done some preliminary inquiry. This should be shared with those doing the due diligence. Frequently the buyer will have identified matters of interest. This allows the development of a priority list.

C. Freedom of Information Act [FOIA] Requests

Freedom of Information Act requests are usually necessary. The information available on line from federal and state agencies is spotty and often insufficient. FOIAs should be done as early as possible as the time lag in getting the response is often considerable, and no agency every really meets the statutory deadlines.

It is tempting to ask for everything that an agency has. That may be a necessity, but it also will slow down the response time. Can the inquiry be focused? Permits, inspections reports, discharge monitoring reports, and enforcement actions for example?

FOIAs are likely peeling an onion. How many layers need to be peeled? There are usually central office files, regional office files, local files, and each inspector usually has their own file. Getting all the way to the bottom requires persistence, tact and time.

Is the transaction public knowledge? If not will making the FOIAs cause issues? This point requires careful consideration. People will always ask why the FOIA is being submitted. There is no requirement to answer the question, but not doing so can be problematic.

Who will make the FOIA requests? Ideally one person should be responsible for all requests. This centralization allows prompt identification of problems, prevents duplicative requests, and allows a consistent message about why the request is being made. Multiple persons making multiple requests are problematic.

D. Internet and Specialized Publications

It is shocking what is available on the internet. It is equally shocking how incomplete and inaccurate such information is. Nonetheless due diligence should include a search of the internet. It can trigger further inquiry.

Specialized publications in the coal industry should also be consulted. They frequently will identify problems, previous transactions, and other matters of interest.

E. Sampling

Whether the buyer should take soil, air, or water samples is a delicate question. It can only be decided on a case by case basis. Often sellers will be very hesitant about such sampling. What happens if samples show a problem? This point has to be considered on the front end of the decision.

If samples will be taken the lead time to mobilize, sample, get the lab results back and consider the results needs to be taken into account. Often the seller will want to take split samples.

Occasionally the buyer will want to consider taking samples through counsel. In theory the results would be protected by the attorney client privilege attorney work product doctrine. This is not free from doubt. An argument exists that such results are not protected. Case law on the subject is sparse and inconsistent. *Environmental Consultants and the Attorney Work Product and Attorney-Client Privilege, Bloomberg Law Reports-Environmental Law vol. 1 no. 4, 2009.*

VI. Priorities

Not all problems are created equal. In the mining context three problems dominate: Failure of impoundments, failure of deep mines with water impounded, and water quality issues. These issues have the potential to be big ticket items.

There are many other potential concerns. Mine fires (not typically considered as an environmental issue), refuse areas (non-impounding), preparation plants, subsidence, coal loading facilities, landfills, and surface mine reclamation.

A. Impoundments and Deep Mines

Impoundments and deep mine containing water can give rise to catastrophic failures. Consideration of these possibilities requires examination by qualified mining engineers. It is not enough to examine the impoundment or the mine. The surrounding area both horizontally and vertically must be examined. Often a failure is triggered by “off-site” conditions.

A thorough review of all available information should be undertaken. This requires identification of potential complicating “off-site” mines. This can be difficult to do. MSHA files should be reviewed as they often are better sources of information about these issues than are other permitting agencies. The seller should be pressed to address these kinds of facilities specifically.

B. Water Quality

Water quality issues can occur with virtually any mining facility. The first step, regardless of the facility, is to determine what NPDES permits exist or have existed for it. Once this has been done the corresponding SMCRA permits need to be examined. The overlap between NPDES and SMCRA permits is a complicating factor in due diligence.

Each discharge point should be identified, and the effluent limits determined. Discharge monitoring reports should be examined to determine compliance. Any monitor only requirements should be identified, and the results examined.

Finally, the potential for the facility to be required to treat additional pollutants must be considered. The obvious example is selenium. Treating more pollutants can be especially problematic. A great deal of attention should be paid to these issues. Large scale treatment can be very expensive.

C. Compliance With Existing Permits

Determining compliance with existing permits is both relatively easy and potentially very difficult. It is easy enough to look at inspection reports, Notices of Violation, and Cessation Orders. It requires, however, a trained eye to visit a mine site and determine what is not being cited that should be.

If possible conversations should be had with the inspector for each of the mines. That may or may not be doable and the inspectors may or may not be candid in their assessments.

D. Future Operations

Potential future operations can be difficult to assess. It requires an understanding of the proposed mine plan and an examination of the likely issues. Two issues predominate; water quality and 404 permitting issues. In addition the length of time to obtain the necessary permits can be a significant question. With regard to water quality the selenium issue is the issue du jour. Equally, obtaining a 404 permit has become increasingly difficult. An experienced mining consultant is invaluable in addressing these kinds of concerns.

III. Conclusion

Environmental due diligence in a coal transaction can be complex with many moving parts. The key to succeeding is an experienced team that establishes the scope of the review early in the process. Outside counsel's responsibility is to manage the process. Keeping it on track and on time requires great coordination.

Update on Recent Environmental Cases

Air Modeling and Class Actions

James Coleman et al. v. Union Carbide Corporation et al., United States District Court, Southern District of West Virginia, Slip Opinion September 30, 2013. Is a class action lawsuit brought action against the various parties about the Alloy plant [Elkem Metals]. In the slip opinion Judge Copenhaver decides various Daubert motions. The Judge also rules on the class certification.

The opinion is important as one of the few decisions addressing scientific evidence and air modeling in the context of a class action. Problems inherent in air modeling historic emissions are discussed in detail. The case is well worth significant study.

Permit Shield

Southern Appalachian Mountain Stewards v. A & G Coal Corporation, United States District Court, Western District of Virginia, Big Stone Gap Division, July 22, 2013, slip opinion. This opinion addresses the so-called permit shield defense. “The key issue in this litigation - whether the CWA’s permit shield protects a permit holder that did not disclose the potential for discharge of a pollutant because, at the time of its permit application, it did not know or have reason to know that it would discharge the pollutant - is an issue of first impression.” Southern Appalachian Mountain Stewards, et al., v. A & G coal Corporation September 13, 2013, slip opinion page 2.

United States District Court held that the permit shield provides protection only for pollutants that are disclosed in the permitting process.

Ohio Valley Environmental Coalition, Inc., v. Marfork Coal Co., Inc., 2013 WL 4506175, Southern District of West Virginia, 2013. This case held that the permit shield requires three elements: (1) compliance with all conditions of the permit, (2) compliance with all express discharge limits in the permit, (3) discharges of pollutants that, although

not specified in the permit, or disclose to the permitting authority and within its reasonable contemplation.

Definition of the Term "Surface"

Faith United Methodist Church and Cemetery of Terra Alta v. Morgan 745 S. E 2d 461 (WV 2013). This case addresses the definition of the word surface when used as a term of conveyance. The Court concluded that the term is not presumptively ambiguous and generally means the exposed area of land, improvements on land, and any part of the underground actually used by a surface owner as an adjunct to surface use.

This case is not an environmental case, but has significant potential for environmental cases. Environmental liability frequently follows property ownership. A surface severance could avoid ownership of contaminated property. This might allow the structuring of the property transaction to avoid environmental liability.

Valley Fills

Ohio Valley Environmental Coalition, Inc., et al. v. Hernshaw Partners, LLC, United States District Court For the Southern District of West Virginia, December 2, 2013. This is one of the cases where citizen groups are pursuing the assertion against a landowner that a valley fill is a point source under the Clean Water Act. The court, considering a proposed amended complaint, cycled through the issue of whether a Valley fill could be a point source and determined that the proposed amended complaint would survive a motion to dismiss for failure to state a claim.

The court's opinion is very preliminary. The court also recognizes that this is a case first impression. This litigation is extremely important.