Chapter 5

Commercial Transactions in a Carbon-Constrained Environment

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Synopsis

§ 5.01. Introduction .................................................................................154

§ 5.02. Environmental Protection Agency (EPA) Rulemaking ........155

[1] — Massachusetts v. EPA ........................................................ 155
   [a] — Scope and Reporting Threshold .......................... 156
   [b] — Non-Compliance ................................................ 159
[4] — Proposed Additional Categories to the Mandatory
   Reporting Rule (MRR) — Petroleum and Natural
   Gas Systems ....................................................................... 159
   [a] — Source Categories .............................................. 160
   [b] — Emissions Sources ............................................. 160
   [c] — Reporting Entities .............................................. 161

§ 5.03. Congressional Initiatives Overview ......................................164

   Clean Energy and Security Act — Waxman
   Markey Bill ........................................................................ 164
   [a] — Scope of Coverage ............................................. 165
   [b] — Emissions Reduction Targets ............................. 165
   [c] — Distribution of Allowances ............................... 165
   [d] — Offsets and Other Cost Containment
       Measures ..................................................................... 166
   [e] — Carbon Market Oversight ................................ 167
   [f] — Interaction with State and Regional
       Programs .................................................................... 167
§ 5.01. Introduction.

For the past two decades, political momentum has been building in the United States for comprehensive, nationwide regulation of greenhouse gases (GHGs) such as carbon dioxide (CO₂) and methane (CH₄). This momentum has manifested itself in the form of state renewable energy standards, voluntary and mandatory regional GHG emission reduction compacts, the introduction of climate change legislation in the U. S. Congress, and GHG emissions monitoring and reporting rules promulgated by the U. S. Environmental Protection Agency (EPA). The cumulative effect of these uncoordinated and relatively decentralized components of climate change policy initiatives should lead industry stakeholders to consider the extent to which such piecemeal efforts to regulate will impact the manner that regulated firms conduct purchase and sale transactions among themselves.

This chapter first examines existing and proposed GHG-related regulations from EPA, various Congressional legislative initiatives, and recently issued guidance by the U. S. Securities and Exchange Commission (SEC) with respect to climate change related disclosures for publicly
traded firms. Next, it outlines the scope and objectives of environmental
due diligence in the context of mergers and acquisitions (M&A) by
and among firms contemplating such matters. Finally, it addresses due
diligence considerations with respect to GHG regulations and policies for
firms contemplating mergers and acquisitions and related transactions,
and explores drafting considerations for legal practitioners involved in the
preparation and review of environmental representations and warranties in
commercial transactions.

§ 5.02. Environmental Protection Agency (EPA)
Rulemaking.

The U.S. EPA has been compelled to act in the context of greenhouse
gas and climate change related matters by judicial mandate as well as by
the policy preferences of President Obama’s administration. Accordingly,
it is useful for interested stakeholders to recall the lead-up to recent EPA
actions.

[1] — Massachusetts v. EPA.

In 1999, more than a dozen environmental, renewable energy and other
organizations petitioned EPA to propose rules to regulate GHG emissions
from new motor vehicles under its Clean Air Act (CAA) § 202(a) authority.\(^1\) The EPA declined on the grounds that it did not have legal authority to
regulate GHG emissions under the Clean Air Act, and that, even if it did, it
would decline to regulate for policy reasons. As a result, various state and
local governmental agencies commenced litigation against EPA to compel
it to regulate mobile source GHG emissions. In 2005, the Court of Appeals
for the District of Columbia ruled against the plaintiffs, and that decision
was appealed to the U. S. Supreme Court.\(^2\)

On April 2, 2007, in Massachusetts v. EPA, the United States Supreme
Court found that GHGs are air pollutants covered by the Clean Air Act.\(^3\) The
Court held that EPA must determine whether or not emissions of greenhouse
gases from new motor vehicles cause or contribute to air pollution which may

\(^1\) 42 U.S.C. § 7521(a)(1).
reasonably be anticipated to endanger public health or welfare, or whether the science is too uncertain to make a reasoned decision. In making these decisions, the Court opined that EPA is required to follow the language of section 202(a) of the Clean Air Act.


In response to the Court’s decision in Massachusetts, EPA announced that GHGs threaten the public health and welfare of the American people. EPA also found that GHG emissions from on-road vehicles contribute to that threat. According to EPA, GHGs are the primary driver of climate change, which can lead to hotter, longer heat waves that threaten the health of the sick, poor or elderly; increases in ground-level ozone pollution linked to asthma and other respiratory illnesses; as well as other threats to the health and welfare of Americans.

EPA’s final findings do not in and of themselves impose any emissions reduction requirements, but rather allow EPA to finalize the GHG standards proposed earlier this year for new light-duty vehicles as part of the joint rulemaking with the Department of Transportation. EPA’s endangerment finding covers emissions of six key greenhouse gases — carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons and sulfur hexafluoride — that have been the subject of scrutiny and intense analysis for decades by scientists in the United States and around the world.


[a] — Scope and Reporting Threshold.

In late 2009, EPA finalized its GHG mandatory reporting rule (MRR), which mandates reporting of GHG emissions from all sectors of the U.S. economy. The mandatory reporting rule does not impose requirements to

4 Id. at 533.
7 The Final Mandatory GHG Reporting Rule (40 C.F.R § 98) was signed by EPA Administrator Lisa Jackson on September 22, 2009 and published in the Federal Register on October 30, 2009 (74 Fed. Reg. 56260-56519). The Final mandatory reporting rule became effective on December 29, 2009.
control or reduce emissions of GHGs; rather, it requires that sources subject to the rule submit annual reports of those emissions to EPA for use in future policy making decisions. For purposes of the rule, GHGs are those identified in the United Nations Framework Convention on Climate Change — carbon dioxide (CO$_2$), methane (CH$_4$), nitrous oxide (N$_2$O), hydrofluorocarbons (HFC), perfluorochemicals (PFC), and sulfur hexafluoride (SF$_6$), as well as other fluorinated gases. For most source categories covered by the mandatory reporting rule, a facility must emit, annually, 25,000 metric tons of carbon dioxide or its equivalent (CO$_2$e) before the rule is triggered. However, several source categories are required to report regardless of whether their emissions meet the 25,000 metric ton threshold.

The mandatory reporting rule requires sources subject to its requirements to begin monitoring on January 1, 2010, with the first GHG emissions reports due on March 31, 2011, and is expected to cover 85 percent of total U.S. GHG emissions from approximately 10,000 facilities. In addition to requiring an annual report, the rule imposes monitoring, recordkeeping, and verification requirements to ensure the accuracy of emissions data submitted. The rule includes provisions allowing sources to use the best available data for January through March 2010, in lieu of the required monitoring methods, to give facilities the time necessary to implement the rule’s monitoring scheme. For most sources subject to the rule, the GHGs reported are those actually emitted by a given facility. However, for suppliers of fossil fuels and industrial GHGs that are subject to the reporting rule, the GHG emissions reported are the emissions that would result from combustion or use of the products supplied. The coal, oil and gas industry sectors were omitted from the initial mandatory reporting rule to allow EPA further time to evaluate and respond to stakeholder comments.

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8 The rule provides a mechanism for converting GHGs other than carbon dioxide to carbon dioxide equivalents. For example, each ton of methane emitted is equivalent to 21 tons of CO$_2$.


10 Id. at 56264.

11 Id. at 56270.
On June 28, 2010, EPA Administrator Jackson signed a final rule that would require mandatory reporting of greenhouse gases from four additional categories: Magnesium Production, Underground Coal Mines, Industrial Wastewater Treatment, and Industrial Waste Landfills. That rule has not yet been published in the Federal Register and is not yet effective.\textsuperscript{12} Underground coal mines subject to the new rule must begin monitoring GHG emissions on January 1, 2011, with the first reports due to EPA on March 31, 2012 and annually thereafter.

For purposes of the mandatory reporting rule, the Underground Coal Mine source category consists of both underground mines under development and underground mines categorized by MSHA as active (where coal is currently being produced or has been produced within the previous 90 days). It includes all underground coal mines that have operational pre-mining degasification systems. Abandoned (closed) mines, surface coal mines, and post-coal mining activities are not included in this source category.

This source category consists of each ventilation well or shaft; each degasification system well or shaft, including degasification systems deployed before, during, or after mining operations; CH$_4$ liberation (including both emitted methane and methane that is combusted) from each ventilation shaft and each degasification well must be included; however, monitoring for each system type may take place at one or more centralized monitoring points that covers all emissions points within that system. Facilities subject to the reporting requirement must report quarterly methane liberation from each ventilation well or shaft, and/or each centralized monitoring point; weekly CH$_4$ liberated from each degasification system, and/or each centralized monitoring point; weekly CH$_4$ destruction from each destruction device or point of offsite transport; quarterly carbon dioxide (CO$_2$) emissions from coal mine gas CH$_4$ destruction where the gas is not a fuel input for energy generation or use; and annual CO$_2$ and nitrous oxide (N$_2$O) emissions from stationary fuel combustion devices using the calculation methods specified by EPA. In addition, each facility must report GHG emissions for any other

source categories for which calculation methods are provided in other subparts of the rule, as applicable.

[b] — Non-Compliance.

Facilities or suppliers that fail to monitor or report GHG emissions, quantities supplied, or other data elements according to the requirements of the applicable rule subparts could potentially be subject to enforcement action by EPA under Clean Air Act sections 113 and 203—205.13 The Clean Air Act provides for several levels of enforcement that include administrative, civil, and criminal penalties. The Clean Air Act allows for injunctive relief to compel compliance and civil and administrative penalties of up to $37,500 per day per violation.14

Actions (or inactions) that could ultimately be considered violations include but are not limited to the following: (i) failure to report GHG emissions (for suppliers, the emissions that would result from combustion or use of the products they supply); (ii) failure to collect data needed to calculate GHG emissions; (iii) failure to continuously monitor and test as required. (Note that merely filling in missing data as specified does not excuse a failure to perform the monitoring or testing); (iv) failure to calculate GHG emissions according to the methodology(s) specified in the rule; (v) failure to keep required records needed to verify reported GHG emissions; or (vi) falsification of reports.


Coal, oil and gas industry sectors were among several categories of GHG emitters that were excluded from the final mandatory reporting rule.

13 Id. at 56360.
14 The Federal Civil Penalties Inflation Adjustment Act of 1990, Public Law 101–410, 104 Stat. 890, 28 U.S.C. 2461, note, as amended by Section 31001(s)(1) of the Debt Collection Improvement Act of 1996, Public Law 104–134, 110 Stat. 1321–373, April 26, 1996, requires EPA and other agencies to adjust the ordinary maximum penalty that it will apply when assessing a civil penalty for a violation. Accordingly, EPA has adjusted the CAA’s provision in Section 113(b) and (d) specifying $25,000 per day of violation for civil violations to $37,500 per day of violation.
Underground coal mines have since been added. (See above). In addition, on March 22, 2010, EPA Administrator Jackson proposed rules that would amend the mandatory reporting rule to include mandatory reporting by owners/operators of petroleum and natural gas systems. These proposals would require reporting of emissions data from the oil and natural gas industries that emit fluorinated greenhouse gases, and from facilities that inject and store carbon dioxide (CO$_2$) underground for the purposes of geologic sequestration or enhanced oil and gas recovery.

[a] — Source Categories.

The proposed amendments to the mandatory reporting rule require reporting of fugitive and vented emissions from the following petroleum and natural gas source categories: offshore and onshore petroleum and natural gas production; onshore natural gas processing; petroleum and natural gas pipelines; onshore natural gas transmission compression facilities; underground natural gas storage facilities; and LNG storage and production facilities. The emissions data to be collected by affected firms is at basin level. As discussed later, basin level monitoring and reporting attempts to address the problem with defining oil and natural gas facilities, an issue unique to oil and natural gas systems. Thus, “facilities” which emit 25,000 metric tons per year of CO$_2$e are subject to the proposed amendment.

[b] — Emissions Sources.

The proposed amendments set forth a lengthy list of emissions sources for which data must be collected. For petroleum and natural gas production facilities, firms must monitor and report fugitive and vented emissions from production wells, including stationary and portable equipment located on all well pads, all structures associated with wells used in production, extraction, recovery, separation and treating of natural gas and petroleum, and gathering facilities, compressors, storage, measurement and all equipment used in

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16 Id at 18636. (Proposed 40 C.F.R. 98.230).
17 Id.
gathering production from multiple wells. Collection and reporting for natural gas processing facilities include emissions from compressors, vent stacks, piping connections, vent and drain lines and gathering lines. Natural gas transmission compression facilities are to monitor and report emissions from compressors, vent stacks, dehydration equipment, condensate tanks and open ended lines and valve stem seals. Reporting for pipeline facilities will encompass fugitive and vented emissions from gathering lines and all associated equipment. As previously referenced, collection and reporting of fugitive and vented emissions with respect to the above sources are to be done at the basin level.

[c] — Reporting Entities.

One component of the proposed amendments that may prove more elusive than might appear at first blush is the designated reporting entity with respect to emissions from onshore petroleum and natural gas production facilities. The proposed amendments assign the reporting responsibility to the “operating entity listed on the state well drilling permit who operates production wells and controls by means of ownership (leased and rented) and operation (including contracted).”\(^\text{18}\) As will be discussed more fully below in the context of due diligence in merger and acquisition transactions, both purchaser and seller will have an interest in ensuring accurate disclosure of compliance obligations with respect to GHG emissions and reporting. One such obligation is determining the correct reporting entity for petroleum and natural gas production facilities.


On May 13, 2010, EPA finalized its “Tailoring Rule,” which establishes new thresholds for greenhouse gas emissions that define when Clean Air Act permits under the New Source Review (NSR) and title V operating permits programs are required for new or existing industrial facilities.\(^\text{19}\) Historically,
the regulatory thresholds for criteria pollutants such as sulfur dioxide and nitrogen dioxide were either 100 or 250 tons per year (tpy). These thresholds, while appropriate for criteria pollutants, are not feasible for GHGs, which are typically emitted in far greater quantities. Without amending the rule to change the thresholds for GHG emissions, the lower emission thresholds would take effect automatically for GHGs on January 2, 2011. Prevention of Significant Deterioration (PSD) permits and Title V requirements at these thresholds would lead to dramatic increases in the number of required permits — tens of thousands of PSD permits and millions of title V permits. State, local, and tribal permitting authorities would be overwhelmed and the programs’ abilities to manage air quality would be severely impaired.

The new GHG thresholds “tailor” the permit programs to limit which facilities are required to obtain New Source Review and title V permits while still covering nearly 70 percent of the national GHG emissions that come from stationary sources, including those from the nation’s largest emitters — including power plants, refineries, and cement production facilities. Small farms, restaurants and many other types of small facilities are not subject to these permitting programs at this time.

Consistent with the mandatory reporting rule, CO$_2$e is the preferred metric for determining GHG emission rates. The EPA will phase in the Clean Air Act permitting requirements for GHGs in two initial steps:

Step 1. (January 2, 2011 to June 30, 2011)

- Only sources currently subject to the Prevention of Significant Deterioration permitting program (i.e., those that are newly-constructed or modified in a way that significantly increases emissions of a pollutant other than GHGs) will be subject to permitting requirements for their GHG emissions under PSD.
- For these projects, only GHG increases of 75,000 tpy or more of total GHGs, on a CO$_2$e basis, will need to determine the Best Available Control Technology (BACT) for their GHG emissions.
- Similarly for the operating permit program, only sources currently subject to the program (i.e., newly constructed or
existing major sources for a pollutant other than GHGs) will be subject to title V requirements for GHGs.

- During this time, no sources will be subject to Clean Air Act permitting requirements due solely to GHG emissions.\(^{20}\)

Step 2 (July 1, 2011 to June 30, 2013)

- Step 2 will build on Step 1. In this phase, Prevention of Significant Deterioration permitting requirements will cover for the first time new construction projects that emit GHG emissions of at least 100,000 tpy even if they do not exceed the permitting thresholds for any other pollutant. Modifications at existing facilities that increase GHG emissions by at least 75,000 tpy will be subject to permitting requirements, even if they do not significantly increase emissions of any other pollutant.

- In Step 2, operating permit requirements will, for the first time, apply to sources based on their GHG emissions even if they would not apply based on emissions of any other pollutant. Facilities that emit at least 100,000 tpy CO\(_2\)e will be subject to title V permitting requirements.

- EPA estimates that about 550 sources will need to obtain title V permits for the first time due to their GHG emissions. The majority of these newly permitted sources will likely be solid waste landfills and industrial manufacturers. There will be approximately 900 additional Prevention of Significant Deterioration permitting actions each year triggered by increases in GHG emissions from new and modified emission sources.\(^{21}\)

In the future, EPA has committed to undertake additional rulemaking to determine whether to phase in additional GHG permitting requirements for smaller sources, among other things.

\(^{20}\) Id. at 31516.

\(^{21}\) Id.
§ 5.03. Congressional Initiatives Overview.

The 2008 fall elections ushered in a Democrat party majority in the House and Senate. Seizing on President Obama’s policy preferences, committees in both chambers of Congress accelerated the introduction of their respective versions of climate change legislation. To date, these competing proposals have been engaged in a horse race as to which would eventually enjoy bi-cameral passage and land on the President’s desk for enactment. Other legislative initiatives such as the Health Care Reform Act took priority for most of 2009 and the first quarter of 2010. However, the recent explosion aboard BP’s deep water Horizon drilling platform in the Gulf of Mexico, and the resulting escape of crude oil into the Gulf have rekindled the climate change and clean energy debate in Congress. It is unclear at this time which bill, if any, will attain final passage and enactment. The following sections briefly summarize the more high profile congressional proposals.


On June 26, 2009, the American Clean Energy and Security Act (ACES Act) was passed by the U.S. House of Representatives by a vote of 219 to 212. The bill contains five distinct titles: I) clean energy, II) energy efficiency, III) reducing global warming pollution, IV) transitioning to a clean energy economy, and V) agriculture and forestry related offsets. Title I contains provisions related to a federal renewable electricity and efficiency standard, carbon capture and storage technology, performance standards for new coal-fueled power plants, R&D support for electric vehicles, and support for deployment of smart grid advancement. Title II includes provisions related to building, lighting, appliance, and vehicle energy efficiency programs. Title IV includes provisions to preserve domestic competitiveness and support workers, provide assistance to consumers, and support for domestic and


164
international adaptation initiatives. The following is a brief overview of the proposed GHG cap-and-trade program contained in Title III and Title V.

[a] — Scope of Coverage.

The bill covers seven GHGs: carbon dioxide (CO\textsubscript{2}), methane (CH\textsubscript{4}), nitrous oxide (N\textsubscript{2}O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs), sulfur hexafluoride (SF\textsubscript{6}), and nitrogen trifluoride (NF\textsubscript{3}). Entities covered by the proposal would include: large stationary sources emitting more than 25,000 tons per year of GHGs, producers (i.e., refineries) and importers of all petroleum fuels, distributors of natural gas to residential, commercial and small industrial users (i.e., local gas distribution companies), producers of “F-gases,” and other specified sources. The proposal also calls for regulations to limit black carbon emissions in the United States.

[b] — Emissions Reduction Targets.

The bill establishes emission caps that would reduce aggregate GHG emissions for all covered entities to three percent below their 2005 levels in 2012, 17 percent below 2005 levels in 2020, 42 percent below 2005 levels in 2030, and 83 percent below 2005 levels in 2050. Commercial production and imports of HFCs would be addressed under Title VI of the existing Clean Air Act and are covered under a separate cap. The bill also establishes economy-wide goals for all sources, including but not limited to those covered by the cap-and-trade program. These goals are the same percentage reduction and timetables as the cap-and-trade program, except that the 2020 target is 20 percent rather than 17 percent below 2005 levels.

[c] — Distribution of Allowances.

The bill utilizes the value of emission allowances to offset the cost impact to consumers and workers, to aid businesses in transitioning to clean energy technologies, to support technology development and deployment, and to support activities aimed at building communities that are more resilient to climate change. Consumers are protected from higher energy prices by providing allowances to electricity and natural gas local distribution companies with a clear mandate that the value of such
allowances be used for the benefit of consumers. Low and moderate income households will also receive a refundable tax credit or rebate. In the initial years of the cap and trade program, approximately 20 percent of allowances would be auctioned. This percentage increases over time to about 70 percent by 2030 and beyond.

Emission allowances are also provided to energy intensive, trade-exposed businesses, merchant coal generators, and oil refiners to aid in their transition away from carbon-based fuels. To support investment in clean technologies, allowance value is used to support advanced vehicle technology and is allocated to states to establish State Energy and Environmental Development (SEED) Accounts to spur renewable energy and energy efficiency programs. Allowances are also provided to support programs aimed at cutting emissions by reducing deforestation in developing countries and for emission reductions from agriculture and forestry sources in the United States. Overall the vast majority of value created through emission allowances will be used to protect consumers and to support technological advances.

[d] — Offsets and Other Cost Containment Measures.

The bill would allow up to two billion tons of offsets to be used for compliance system-wide — one billion from domestic sources and 1 billion from international sources. If the domestic supply of offsets is insufficient, EPA can raise the international limit up to one and one-half billion, but the two billion total still applies. The president can recommend to Congress that the limits on offsets should be increased or decreased. For international offsets, beginning in 2018, one and one-quarter offset credits would be required to be surrendered for each ton of emissions compliance, but there is no such discount for domestic offsets. The EPA would determine the list of eligible offset projects based on recommendations from an Offsets Integrity Advisory Board. Title V of the bill establishes an offset program specific to domestic agriculture and forestry sources. This program would be administered by the Secretary of Agriculture.

Other cost containment measures in the bill include a two-year rolling compliance period with unlimited banking, unlimited next-year borrowing
with no interest, and borrowing of up to 15 percent of a compliance obligation from years two to five beyond the current calendar year at eight percent annual interest. To further contain costs, the bill also creates a strategic allowance reserve auction using a small percentage of allowances from future years. The initial minimum price level for the auction would be set at $28 in 2012, and rise at five percent plus inflation for 2013 and 2014. Beginning in 2015, the reserve auction trigger price would be 60 percent above the three year rolling average of the market price of allowances.

The Congressional Budget Office’s (CBO) analysis of the bill concluded that it would impose costs of $175 per household and that households with incomes in the lowest 20 percent would receive a net benefit of $40 annually. EPA’s analysis of the bill estimated that it would cost households between $80-111 per year. Industry groups have estimated the costs as being significantly higher.

[e] — Carbon Market Oversight.

The bill would require the Federal Energy Regulatory Commission to regulate the cash market in allowances and offsets, and assigns the Commodity Futures Trading Commission the responsibility for regulation and oversight of any derivatives markets unless the president decides otherwise. The bill also prohibits over-the-counter trading of derivatives.

[f] — Interaction with State and Regional Programs.

The bill provides that states could enact more stringent climate regulations with the exception of cap-and-trade programs. State trading programs would be put on hold from 2012 to 2017 to give the federal system a chance to get started. Holders of allowances issued by California, the Western Climate Initiative, or RGGI (Regional Greenhouse Gas Initiative) before December 31, 2011 can exchange these state allowances for federal allowances.


[a] — Clean Jobs and American Power Act
(Kerry – Boxer).

The Clean Jobs and American Power Act (i.e., Kerry – Boxer Bill) was introduced in Senate on September 30, 2009 but got nowhere.
On May 12, 2010, Senators John Kerry (D-Mass.) and Joe Lieberman (I-Conn.) revealed comprehensive climate change legislation setting mid- and long-term carbon emission reduction goals. The legislation offers incentives to increase domestic production of fossil fuels and alternative clean energy sources, while using a cap and trade program to reduce carbon emission levels 17 percent below 2005 levels by 2020, 42 percent by 2030, and 83 percent by 2050.

The Kerry-Lieberman proposal, titled the American Power Act, is somewhat narrower in scope than the cap-and-trade scheme in the Waxman-Markey bill passed by the U.S. House of Representatives in 2009, and would cover only 7,500 factories and power plants. It would restrict EPA's authority to regulate greenhouse gases under the Clean Air Act while also preempting state or regional greenhouse gas regulations. Producers and importers of refined petroleum products, while not subject to cap and trade under the proposed bill, would be required to purchase allowances at a fixed price.

The bill includes several political compromises, such as $54 billion in loan guarantees for the nuclear energy industry, a $2 billion fund for carbon capture and sequestration technology, and increased protection for states. Most notably, states will gain veto power over any drilling activity that takes place within 75 miles of their coastlines, as well as receiving a share of the revenue from any expanded offshore drilling for oil and natural gas bordering their coastlines.

Kerry has predicted that within a year, the Senate will gather the 60 votes necessary to pass this legislation, yet much skepticism remains as to whether it will actually become law. Experts indicate that several obstacles stand in the bill’s way: upcoming midterm elections, the Senate’s packed agenda, and indifferent responses from both environmental and industry leaders. Lieberman commented that releasing this version of the bill opens up the next negotiating process, suggesting that the legislation could undergo many changes before reaching its final product.

The Securities and Exchange Commission Regulation S-K provides the framework that publicly traded companies must follow when making disclosures and reports to the SEC. These disclosures include analyses of the potential positive or negative impacts on a company due to new laws and regulations or other developments affecting a company’s business. On February 2, 2010, the SEC issued an interpretive release regarding disclosures associated with climate change.23 This document is intended to assist publicly traded companies in assessing whether climate-related impacts on their businesses will require disclosures to the SEC under Regulation S-K.


The SEC identified recent federal and state legislation and regulatory developments that may trigger reporting under the Items described above. These include EPA’s endangerment finding for GHGs under the Clean Air Act, EPA’s mandatory GHG reporting rule, proposed Cap & Trade Legislation and several state laws related to GHG emissions. The guidance highlights the following possible consequences of pending legislation and regulation related to climate change:

i. Costs to purchase, or profits from sales of, allowances or credits under a “cap and trade” system;

ii. Costs required to improve facilities and equipment to reduce emissions in order to comply with regulatory limits or mitigate the financial consequences of a “cap and trade” regime; and

iii. Changes to profit or loss arising from increased or decreased demand for goods and services produced by the registrant arising directly from legislation or regulation, and indirectly from changes in costs of goods sold.

23 See 75 Fed. Reg. 6290 (Feb. 8, 2010).
Similarly, the SEC release underscores a corporation’s obligation to evaluate the impacts of international treaties and agreements, including the Kyoto Protocol, European Union Emissions Trading System and any other potential future agreements related to climate change. The impact of international accords are identical to those outlined above for domestic legislation and regulation.


The SEC guidance notes that legal, political and scientific developments regarding climate change may create new opportunities or risks for registrants. The examples provided in the guidance include decreased demand for goods that produce significant GHG emissions, increased demand for goods that result in lower emissions than competing products, increased competition to develop innovative new products, increased demand for generation and transmission of energy from alternative sources, and decreased demand for services related to carbon based energy sources, such as drilling services or equipment maintenance services. All of these potential impacts could potentially trigger reporting and disclosure obligations.


The guidance further recommends that registrants consider whether significant physical impacts related to climate change could impact a firm’s operations and results. These risks include businesses that are affected by severe weather or climate-related events. Severe weather can potentially damage physical facilities or disrupt manufacturing and distribution systems of both the registrants and their suppliers. The guidance also discusses the potential impact of rising sea levels on coastal facilities and operations.

§ 5.05. Commercial Transactions and Environmental Due Diligence.

[1] — Environmental Due Diligence Overview.

The objective of environmental due diligence in commercial transactions is to identify material environmental conditions, risks and constraints attendant to the purchase of an asset or going business concern. These include
the discovery of matters such as legacy liabilities, operational/ongoing liabilities or non-compliance, facility expansion/modification mandates and constraints, mandated modifications of operational practices, and facility-based environmental factors (contamination, wetlands, endangered species) affecting expansion or construction opportunities. Accordingly, the due diligence process should be designed and planned to encourage sellers to meet its environmental disclosure obligations, to satisfy fiduciary duties to purchaser's shareholders, and to identify transactional and regulatory tools to resolve environmental issues.

The type of transaction at issue will inform planning and the implementation of an environmental due diligence strategy. Preliminary considerations that may affect the scope of the environmental due diligence process include whether the transaction will be structured as an asset purchase or stock purchase. In an asset purchase, generally a purchaser can shield itself from the seller's liabilities. There are, however, exceptions to the general rule of liability avoidance. These include a “de facto” merger or consolidation, “product line” or “continuation of the enterprise,” express assumption of environmental liabilities, and fraudulent transfers. Distinguished from an asset purchase, the purchaser in a stock purchase transaction steps into the seller's shoes, and acquires any liabilities that the seller may have. In a transaction between natural resource exploration and production firms, land and mineral rights will be the predominant asset for which environmental due diligence will apply. Under various federal and state statutes and regulations, a purchaser of land will become liable for environmental contamination and hazards and the concomitant remediation costs unless it qualifies for one of the statutory landowner liability protections. In order to qualify for such protection, firms must conduct environmental due diligence in accordance with specifically accepted site assessment protocols and EPA's “all appropriate inquiries” rule. Thus, firms should give significant consideration to planning and implementing their due diligence strategy to take advantage of available environmental liability avoidance laws and regulations.

The seller’s objective in a purchase and sale transaction is to sell property “as-is” with full releases and indemnification from the purchaser with minimal impact upon price. To accomplish this objective, seller’s counsel will pursue an agreement which contains limited environmental representations, warranties and indemnities, broad releases from the purchaser, terms to control the type and timing of cleanup of a contaminated site, provisions that make the purchaser responsible for any change in use of the property or prohibit certain uses on the site (e.g., day care centers, residences, schools, parks), and promote provisions that will make purchaser responsible for monitoring and maintaining any engineering and institutional controls.


From the buyer’s perspective, its objective is to purchase property without any responsibility for pre-existing environmental contamination. To that end, counsel for the purchaser will pursue a final agreement containing broad environmental representations, warranties and indemnities from Seller, which establishes escrows or purchase price reduction provisions to mitigate the financial impact of known environmental conditions, and which seeks purchaser’s ability to control the type and timing of any needed remediation. Environmental due diligence of property suspected of contamination will include a Phase I Environmental Site Assessment. In the context of GHG-related issues, the purchaser will want to ensure that its Phase I ESA is sufficiently broad to include an evaluation of seller’s compliance with the mandatory reporting rules. A prudent purchaser may also examine the extent to which seller’s facilities would be affected by the GHG Tailoring Rule discussed supra. The current political climate would also suggest that, in anticipation of passage of national climate change legislation, a purchaser’s due diligence should include an assessment of the cumulative impact of GHG emissions from seller’s facilities and property with due regard for the decentralized nature of sources of emissions as is the case in the petroleum and natural gas production sector.

Once parties to a purchase and sale transaction have decided on the scope of the due diligence process, the seller through disclosures, and the purchaser through investigation, will consummate the due diligence period. This period will flesh out the material environmental issues involved in the proposed transaction and enable the purchaser to assess the relative risks with proceeding to closing. Therefore, before and during the due diligence period, the parties must mutually agree on the process for resolving any environmental concerns that have been identified. The risks attendant to environmental concerns are most commonly addressed through escrow and indemnification provisions in the sales agreement, purchase price reduction, and a pre- and post-closing remediation schedule. Purchasers may also seek to further mitigate their future liabilities by purchasing environmental contingency liability insurance, such as Pollution Legal Liability Insurance or Cost Cap Insurance Policy lines.

As previously referenced, purchasers may conduct Phase I Environmental Site Assessments (ESA) to identify whether property has been contaminated. However, in the context of GHG emissions, a Phase I ESA may not be sufficient to fully address whether the seller has complied with the collection and reporting of GHG emissions. Thus, a Phase II ESA may be necessary to ascertain whether seller has collected emissions data from all sources and facilities, and whether the collection and testing methodologies comply with applicable regulations, such as the mandatory reporting rule. The decision by purchaser to seek access to seller’s facilities to conduct a Phase II ESA may be dismissed by seller as unnecessary or overly intrusive and disruptive to the seller’s business operations, in which case, the seller’s representations and warranties contained in the sales agreement should specifically address climate-related issues.


The seller’s officers and employees will possess knowledge concerning seller’s facilities and operations, the disclosure of which purchaser should obtain during its due diligence investigation. Thus, with respect to seller’s property and facilities, purchaser should ensure it propounds broad requests
for information and supporting documentation. For example, the purchaser’s investigation should minimally include requests for information in the seller’s possession or control regarding the physical condition of seller’s property and facilities. These requests may include information regarding such matters as the location, use and age of storage tanks on or under the property. Similarly, the purchaser should seek information regarding the nature and extent of lakes, impoundments, pits, catch basins and other open conduits used for the storage or treatment of discharges.

In the context of GHG emissions, purchaser should seek information regarding the source and type of equipment and facilities that emit regulated gases, and information regarding any emission reduction technologies currently in operation. Further, the purchaser should seek information regarding air and water quality issues on seller’s properties and adjoining properties, the location and use of hazardous material management facilities, and the location and type of fuel supplies for seller’s operations. Clean Air Act Operating permits should be carefully reviewed to ascertain the extent to which any planned modifications or new construction would be affected by the GHG Tailoring Rule discussed supra. Purchaser may also wish to evaluate the potential for GHG emissions reductions within seller’s operations and the costs associated with retrofitting facilities to capitalize on generating offset credits in anticipation of possible cap and trade legislation.

The existence of newly established regulations such as the GHG Mandatory Reporting Rule and GHG Tailoring Rule may present unique challenges with respect to seller’s knowledge of its compliance with such regulations. Some firms may not have concerned themselves with GHG emissions in the past. Thus, the parties to a transaction should devote sufficient resources during due diligence to identify the extent to which seller is subject to these rules. At a minimum, the seller should know its carbon footprint in order to evaluate whether it is subject to collection and reporting requirements with respect to GHG emissions regulations. Moreover, the purchaser should position itself to determine whether its purchase of seller’s facilities will trigger its own reporting obligations under the GHG Mandatory Reporting Rule, particularly where the purchaser may not have fully evaluated its own pre-purchase reporting obligations.
The purchaser should attempt to mitigate its potential exposure to regulatory non-compliance issues and hidden compliance costs where seller’s knowledge of material climate-related risks is uncertain through appropriate representations, warranties and indemnities in the sales agreement. These important provisions will often be the most negotiated terms of the purchase and sale agreement.

§ 5.06. Environmental Representations and Warranties.

Environmental representations and warranties will be structured with very different purposes in mind, depending on which side of the transaction a firm is situated. For example, the seller will propose provisions that will limit the seller’s post closing liabilities as to environmental matters that are reasonably ascertainable from a proper ESA. Conversely, the purchaser will seek broad protections for post-closing contingencies, particularly where reasonable due diligence may not reveal the existence or full extent of environmental issues associated with the assets and facilities subject to the sales agreement. Additionally, the purchaser may be exposed to risks with respect to regulatory non-compliance matters in the case of newly established regulations such as the GHG Mandatory Reporting Rule. Simply put, seller’s knowledge of these matters may be limited by the seller’s inexperience in complying with such regulations.

Although the particular circumstances and facts surrounding each transaction will dictate the scope and extent of environmental representations and warranties, there are common provisions one would expect to find in most purchase and sale agreements. For example, the agreement will customarily contain provisions that seller either has not used materials defined as hazardous under environmental laws, or that any use is in material compliance with such laws. The purchaser may also seek language wherein the seller covenants that it is unaware of past environmental issues affecting the transferred assets which could lead to future liabilities on the part of the purchaser.

Perhaps seller’s affirmative statement that, to the best of seller’s knowledge, it is in material compliance with Environmental Laws will suffice. However, drafters may consider the seller’s limited experience
with climate change regulations such as the GHG Mandatory Reporting Rule and Tailoring Rule in crafting additional language with respect to seller’s representation and warranties. In the context of the GHG Mandatory Reporting Rule, purchasers might very well insist upon representations in the sales agreement that seller has evaluated its emissions of covered substances under the MRR, and that it is either exempt from the reporting obligations, or that its emissions exceed the thresholds established in the rule. If the latter, the purchaser should consider language whereby the seller represents that it has complied with all required testing and monitoring methodologies promulgated by the GHG Mandatory Reporting Rule, that it has properly verified the results of such testing and monitoring, and that it has substantially complied with the reporting obligations specified in the rule.

Similarly, the purchaser should consider the applicability of, and the extent of compliance with, the Tailoring Rule with respect to seller’s facilities and property. Therefore, the purchaser should consider whether additional language is prudent in light of the new Tailoring Rule. For example, an affirmative representation that to the best of seller’s knowledge, seller’s facilities are in material compliance with all existing Clean Air Act operating permits, including, but not limited to, the existence and use of best available control technologies if required under the CAA and Tailoring Rule.

§ 5.07. Conclusion.

The rapid evolution of climate change related regulations, legislation and regional mandates requires that firms engaged in commercial transactions give due consideration to the effect that these complex regulatory systems may have on a firm’s monitoring, testing and reporting obligations in the area of GHG emissions, as well as the potential costs associated with compliance. In large part, a firm’s inexperience with the regulations discussed in this chapter, and the uncertain future of federal legislation should invoke the need for the firm to evaluate its own business model in light of these evolving climate change related obligations. Firms engaged in merger and acquisition activity must also consider the economic and regulatory consequences associated with acquiring assets and facilities from other companies that
have not given sufficient analysis and attention to the regulatory environment with respect to climate change related matters. In a business environment where firms seek certainty in the regulatory context, a carefully constructed due diligence plan regarding climate change related matters is critical in commercial transactions, especially in light of limited experience with new GHG related regulations. Purchasers should thoroughly consider the short and long term impact of such regulation on its business, products and image when deciding to acquire additional assets that, singularly, or in combination with its own assets, require compliance with these regulations.