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Regulatory Affairs: Best Practices for Contractual Allocation of Environmental Liability Following Resolute FP Canada Inc v Ontario (AG)

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Welcome to our *Regulatory Affairs* series, developed to provide timely updates on hot topics across the vast world of regulatory law; strategic insights on regulatory fundamentals; and a look at environmental and Aboriginal law topics, which frequently intersect with regulatory matters. As always, we are here to help.

In recent years, remediation costs for contaminated sites have been on the rise. The costs associated with the assessment, remediation and/or monitoring of contaminated sites on federal land was $516.3 million in 2021, an increase of over 70% since 2016.[1] Similarly, estimates for the cleanup cost of oil and gas infrastructure in Alberta range from $58.7 billion to $70 billion.[2]

In the 2019 decision in *Resolute FP Canada Inc v Ontario (AG)* (*Resolute*), the majority of the Supreme Court of Canada declined to enforce a generously drafted indemnity provision on the basis that the factual matrix narrowed the scope of the indemnity.[3] This has important implications, because parties often include broadly drafted indemnification provisions in transactions involving the transfer of land or financial arrangements where lands are offered as collateral (Asset-Based Transactions).

The key to success in allocating environmental risk in Asset-Based Transactions is knowledge, from the purchaser's/lender's perspective, and adequate and timely disclosure, from the vendor's/borrower's perspective, with respect to the target assets. Assessing environmental liability is a standard practice, but if the contract terms fail to properly capture the risk allocation, parties may end up undertaking more risk than they had originally anticipated. Drafting these provisions in broad and general terms so as to encompass every possibility of liability may not transfer all of the risk to the vendor/borrower. In *Resolute*, the Supreme Court refused to apply an indemnity for "any claim, action or proceeding, whether statutory or otherwise" to a first party regulatory order.[4] Below are three considerations when allocating environmental risk in Asset-Based Transactions.

Conduct Environmental Site Assessments to Confirm Site-Specific Information

The assessment and management of environmental risk in Asset-Based Transactions is not one-size-fits-all. The degree of knowledge that a prospective purchaser should acquire about a target asset as part of the due diligence process will depend on the characteristics of the asset in question, including prior and current uses (which may indicate a higher risk of contamination), geographical location and context (which could increase the risk of migration of contaminants to neighboring properties), and proximity to sensitive environmental features (such as rivers and watercourses), etc.

Based on the above factors, the purchaser may determine that an environmental site assessment (ESA) is necessary to quantify the risk associated with the asset. Further, a sophisticated vendor may wish to narrow its representations and warranties and qualify them to the results of the ESA, stating that the vendor's knowledge is limited to such report.

ESA may be undertaken by the purchaser or the vendor, but they are generally undertaken by the vendor due to the time and cost associated with completion of the ESA. Where the purchaser is relying on an ESA commissioned by the vendor (or where the vendor is seeking to narrow its representations and warranties to knowledge acquired through the vendor's report), the purchaser should: confirm that the report may be relied on by third parties; ensure that the report is recent and prepared by reputable environmental consultants; assess whether the report was made under any assumptions and whether any such assumptions are reasonable; and understand the scope of the report and any exclusions or limitations. For transactions involving assets with suspected contamination or with a higher incidence for contamination, it is advisable that both parties retain their own environmental consultants.

As a result of its due diligence investigations of the target asset, the prospective purchaser may discover contamination issues. In such cases, addressing known contamination by way of a broadly-worded indemnity—or failing to explicitly address the issue in the agreement—may result in the purchaser assuming liability for such contamination.[5] In our experience, it is better to address the issue of known contamination by way of indemnification provisions specifically targeted at such contamination.

Representations and Warranties Should Consider the Issue of Control of the Asset

In addition to issues relating to the particular characteristics of the asset, the purchaser should consider the issue of control. It is possible that the party operating the site is not the same as the vendor. Moreover, it is possible that the vendor has acquired the asset from a prior owner, who may have used the asset for a different purpose. One of the greatest challenges of managing environmental risk is that contamination can change overtime. It may go undetected for several years, result in off-site migration and significantly increase damages.[6]

A prospective purchaser should investigate not only the vendor's use for the asset, but also that of parties actually in control of the asset. Where the vendor acquired the asset from a prior owner, the purchaser should do investigations about prior uses of the asset. In these cases, a mere representation that the vendor has "no knowledge" about the presence of contaminants or the breach of environmental laws will likely be insufficient.

The Transfer of the Asset on an "As Is, Where Is" Basis May Not Be Sufficient to Exempt the Vendor from Liability

There are two primary forms of environmental indemnities: "our watch, your watch" and "as is, where is." In an "our watch, your watch" transaction, the vendor provides an indemnity for environmental liabilities attributable to events or circumstances that took place prior to closing. This provides the purchaser with certainty as to its level of risk, but is a serious undertaking by the vendor, as they are divesting themselves of an asset without reducing their environmental liability.

In an "as is, where is" transaction, the environmental risk is assumed by the purchaser, and the vendor generally disclaims any representations regarding environmental concerns. This is generally advantageous for the vendor as the purchaser is entering into the transaction at its own risk. However, in limited circumstances, the vendor in such transactions may still be held liable for past contamination if they had had knowledge or suspicions about such past contamination but failed to disclose it to the purchaser. While the "as is, where is" clause could defeat a claim in contract, actively concealing an environmental liability could be considered a fraudulent misrepresentation, exposing the purchaser to liability in tort.[7] This is true even if the purchaser could have uncovered the contamination with proper due diligence.[8] In order to avoid potential liability for any latent defects, a prospective vendor should provide full disclosure of any known or suspected risks to the purchaser and provide site access to the purchaser and the purchaser's consultants to conduct any investigations.

Implications for Canadian Companies

Both purchasers and vendors should ensure that environmental risks are properly allocated in an Asset-Based Transaction. A careful review of environmental risks should consider whether the level of environmental investigation is appropriate in light of the asset's characteristics, whether the representations and warranties cover all of the parties that historically had control of the asset, and whether the transaction is intended to be "as is, where is" or "our watch, your watch." A conscious allocation of risk is advantageous for both purchaser and vendor as it clarifies the business rationale underlying the transaction.

Resolute suggests that boilerplate indemnities can pose a risk if a court is called on to interpret the

agreement. The scope of the indemnity should be specific to the assets, incorporate the transaction's representations and warranties, and reference any known or suspected contamination, where possible.

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[1] Treasury Board of Canada Secretariat, "Federal Contaminated Sites Inventory Financial Summary" (last accessed 31 August 2021), online: <tbs-sct.gc.ca/fcsi-rscf/reporting-rapports-eng.aspx?t=E&g=C&fy=2020-2021>.

[2] Clare Clancy, "Cost estimates to clean up oil and gas wells lack transparency, says advocacy group", *Edmonton Journal* (18 July 2019), online: <edmontonjournal.com/news/politics/cost-estimates-to-clean-up-oil-and-gas-wells-lack-transparency-says-advocacy-group>.

[3] 2019 SCC 60 [*Resolute*].

[4] Resolute at paras 14, 26-34.

[5] *862590 Ontario Ltd. v Petro Canada Inc*., [2000] O.J. No. 984.

[6] See, e.g. *ConocoPhillips Canada Resources Corp. and Shell Canada Limited*, 2019 ABQB 727 (where an exploration well drilled in the 1970s was never put into production but was found to be contaminating a nearby bank and pond in 2010).

[7] See, e.g., *1234389 Alberta Ltd. v 606935 Alberta Lvd.*, 2020 ABQB 28 (vendor failed to disclose an ESA).

[8] *Performance Industries Ltd. v Sylvan Lake Golf & Tennis Club Ltd.*, 2002 SCC 19 at paras 68-6.
