

ENVIRONMENTAL, HEALTH AND SAFETY PROVISIONS IN CONTRACTS

Managing Risks & Leveraging Opportunities with
EHS Auditing



A White Paper by

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*A Resource for Companies and
Their Business Partners*



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Environmental, Health & Safety (EHS) Provisions in Contracts: Managing Risks & Leveraging Opportunities with EHS Auditing

1.0 INTRODUCTION

Environmental, health and safety (EHS) issues are subject to extensive regulation by national, state, regional and local authorities. This white paper discusses:

- How EHS Risks Arise in Contracts
- Scenarios
- EHS Criteria for Contract Audits
- Contract Life Cycle & EHS Auditor Value



EHS regulations touch many aspects of an organization's operations, and create a myriad of compliance requirements. The regulations also include authority for government entities to impose substantial fines, violations, or penalties. Penalties for U.S. environmental statutes can be up to \$1,000 or \$5,000 – even \$25,000 per violation per day, depending upon the statute. The definitions of “violation” and “per day” are expansive; the available penalties can skyrocket quickly. Agencies also have the authority to impose remedies including injunctive relief, the requirement to install and operate pollution control devices, or to implement management practices as specified. Non-compliance with environmental regulations can also become a public event, affecting an organization's reputation, attractiveness to potential talent, or relations with customers and suppliers.

Health and safety (H&S) regulations also impose compliance requirements. It is common for organizations to refer to them collectively as “EHS.” Enforcement remedies for H&S regulations are not nearly as substantive as for environmental regulations.

It has become common for EHS issues to be addressed in contracts between parties. Contract terms often frame baseline conditions, allocate responsibilities and costs, and provide remedies for parties to the contract. Contract management (or lack thereof) can create substantial risks for organizations. EHS Auditing can be used to reduce these risks, and to leverage opportunities provided by these contracts.



Key Terms

For purposes of this white paper:

- “EHS” is used when the concept applies to both Environmental and Health & Safety
- “Environmental” is used when the concept applies exclusively or primarily to matters related to environmental laws, regulations, risks, or liabilities.



2.0 HOW EHS ISSUES ARISE IN CONTRACTS

EHS regulations and requirements pose substantial burden on organizations¹. Consequences of non-compliance can be substantial. They can restrict an organization's operations, operating costs, capital investment requirements, public image, or its ability to achieve business goals. If the impact or risks associated with environmental matters is significant enough, it may trigger provisions for financial filings or disclosures.

This risk is growing. There are more regulations; furthermore, the reach of the regulations extends up the supply chain and down the value chain. Reporting obligations are growing. Many of these reporting obligations are "voluntary," but form the basis for inclusion in industry channels of commerce.

With the increasing profile of EHS issues, and the corresponding costs of non-conformance, it is only logical that they are now routinely included in contractual provisions between parties. These contractual provisions are not "enforceable" in the traditional sense of EHS auditing – in the U.S., by the Environmental Protection Agency (EPA) or the Occupational Safety and Health Administration (OSHA), or other applicable state or local entities). But these contracts are enforceable by other party(ies) to the contract. Costs can be substantial.



Applicable Contracts

Organizations enter into many kinds of contracts that often include EHS provisions, including those listed below.

- Purchase and sale agreement (real property; business; assets)
- Master Services Agreement
- Joint Venture or business agreement
- Contract partnership agreement
- Lease agreement
- Contracted services (office management, janitorial, cafeteria, etc.)

¹ It is standard practice – indeed, commonly required – for organizations to manage social and corporate responsibility issues – also commonly known as "Sustainability." The principles and examples in this white paper can be applied to Sustainability and other non-financial reporting.



- Contracted labor (onsite manufacturing, toll manufacturing, operation of portion of a facility)
- Insurance policy

Risks associated with EHS provisions of contracts may arise through one, or a series of events.

How Risks Arise

Many transaction contracts are negotiated by transactional specialists, and agreed to by executive management. Once a transaction is closed, the transactional specialists move on, and executive management concentrates on achieving business objectives (integrating the new business, reorganizing after a spin-off, etc.). Contractual provisions may be so general as to pose difficulty in implementing or enforcing. Some provisions may not apply, calling the validity of other provisions into question. Contractual provisions are not given a home in the organization with management or enforcement obligations. As a result, parties fail to fulfill their obligations.

Sales and Marketing may agree to EHS provisions in contracts with customers without realizing what the provisions entail. Organizational groups that would normally be responsible for these provisions (EHS, Quality Assurance, and Procurement) are not aware of the requirements until the organization is advised by a key customer that they are not fulfilling a contractual provision.

Contracts may be boilerplate, with little room for negotiation. The EHS provisions may be accepted without realizing the responsibilities or the risks of non-conformance.



Missed Opportunities

Organizations may also fail to realize they have contractual protections for EHS issues. As a result, they can squander an opportunity to re-assign responsibility or to recover costs.



3.0 SCENARIOS

Here are three scenarios that illustrate how companies incur environmental and safety obligations via contract, and how these contract provisions can pose risk to the organization. The scenarios include elements of contracts encountered in the author's professional experience.

Scenario 1: Audit to Terms of Asset Purchase Agreement: Manufacturing

Alpha Products purchased the assets and operations of Fanuma Manufacturing Company. In the Asset Purchase Agreement (APA), Fanuma represented that they were in substantial compliance with environmental regulations at the date of closing. Fanuma agreed to pay costs (up to a specified amount) associated with non-compliance at the date of closing. Alpha must identify and report matters of non-compliance to Fanuma within 180 days of closing. Costs subject to recovery must be incurred within two years of closing.

Alpha commissions an environmental compliance audit, which yields the findings listed below.

- **Wastewater discharge:** The discharge of wastewater from Fanuma's Facility #1 exceeded temperature limits for 30% of the measurements in the prior twelve months, and 75% of the summertime measurements during the last five years. The corrective action could require installation of a cooling tower, at a cost of \$5 million – and a time frame for one year for permitting and construction. Potential consequences could also include fines or penalties from regulatory authorities.
- **Hazardous Substance Management:** Fanuma's Facility #2 stores and uses hazardous substances that are not included in permits, written plans, or notifications to agencies that would be responsible for initial response to an incident. The corrective action could be to contact appropriate authorities, and to update permits and plans. There is risk that the agency may not approve revised permits or plans, and Facility #2 would be required to remove these substances. This could impact Facility #2's operations.
- **Tank Testing:** Fanuma's Facility #3 operates aboveground storage tanks (ASTs). An industry code, not expressly required by the local regulatory authority but often invoked other parties, requires tank integrity testing and inspection of the tank floor every ten years. Fanuma inspected the ASTs nine years before the deal closed. Alpha commissioned an integrity test shortly after closing, and discovered a leak. Corrective action could require notification to regulatory authorities, removal of product from the tank, and repair of the tank. Discovery of





the leak would also likely require testing of subsurface media (soil, soil vapor, and/or groundwater) for potential impact; if contamination is detected, the regulatory agency would require further assessment and possibly remediation. Depending upon the extent of contamination, these activities could take five or ten years or more.

- **Plan Signature:** Fanuma prepared a Spill Prevention Control and Countermeasure (SPCC) Plan, which is required by environmental regulation. The SPCC Plan was signed, but not by an individual with a Professional Engineer (P.E.) credential that is required by the regulation. The corrective action could be as simple as finding a P.E. willing to sign the SPCC Plan.

The findings in Alpha's environmental compliance audit differ in many aspects, including those listed below.

- **Type of driver:** The criteria for the gap noted, and the driver for the corrective action(s) differ. The compliance criterion for the wastewater discharge is clear. Fanuma's Facility #3 was in compliance with the criteria for testing their ASTs. Furthermore, the industry standard that drives this test may not be referenced in environmental regulations or permit.
- **Certainty of corrective action:** The corrective action may be simple, or it may be more complicated. As the SPCC Plan example illustrates, obtaining may be sufficient. However, the P.E. could identify additional non-compliance items that require further attention – and costs.
- **Materiality:** The materiality of the issue differs. Obtaining a review and signature from a P.E. can involve nominal costs, or Alpha may find an in-house P.E. willing to do this as part of their job. If construction of a cooling tower is required to meet wastewater discharge permit limits, this could involve millions of dollars in costs.
- **Possibility of unintended consequences:** Addressing one corrective action could trigger the need to address other gaps. If Alpha decides to construct a cooling tower, the regulatory agency may notice the history of non-compliance and bring enforcement action. The discovery of the leak in the AST could trigger a lengthy and costly investigation and remediation process. Testing of soil or groundwater could yield discovery of legacy contamination that complicates the assessment and remediation. Legacy contamination could originate from Fanuma, or from prior owners or neighbors.
- **Timing of incurred costs:** Some corrective actions can be completed within the timeframe that allows Alpha to recover costs from Fanuma. It may not be possible to complete other corrective actions in time to recover costs from Fanuma.

Both parties should have experience environmental resources supporting them throughout the transaction, including as long as either party has exposure. EHS Auditing skills are invaluable in creating auditable terms, effective management systems, and supportable monitoring procedures.



Scenario 2: Joint Service Agreement: Property Manager & Retail Tenant

Pento Properties owns and manages Meta Mall and many other shopping malls. Food courts are a standard feature at shopping malls. Pento Properties leases restaurant spaces to over 20 restaurants at Meta Mall, including many familiar restaurant chains, and to popular regional and innovative artisan restaurants. Restaurants use substantial quantities of water. They generate equally substantial quantities of wastewater from washing food, washing dishes, and janitorial services. Restaurants, of course, cook food – which involves using fuel. Fuels include electricity, natural gas, charcoal, and wood.



Restaurants in the food court generate wastewater and air emissions, which are both subject to environmental regulations. The regional air quality authority imposes limits on air emissions to protect public health, and to prevent nuisance odors. The local wastewater regulatory authority requires treatment to remove oil, grease, and some biological material before any entity may discharge the wastewater to the municipal sewer.

Pento Properties maintains permits with the regulatory agencies, and is responsible for compliance – and fines and penalties arising from non-compliance. Pento owns and operates a network of air emissions collection ducts, and an air pollution control device to remove droplets of grease and particulates. Pento Properties owns and operates the network of wastewater collection piping, and a small onsite wastewater treatment system.

Pento's lease agreement with tenant restaurants includes limits on the quantity and quality of air emissions they produce, and wastewater they generate. One lease provision requires tenant restaurants to submit their fuel bills to Pento every month. If a tenant restaurant fails to submit fuel bills in a month, Pento charges a penalty that begins at \$1,000 for the first occurrence and increases for subsequent occurrence. If a tenant restaurant exceeds their allocated fuel inventory, Pento has the contractual right to evict the restaurant on 30 days' notice.

Gamma Grill, a longtime tenant of Pento Properties, has traditionally used a gas-fired grill to prepare food. Gamma Grill switched to wood-fired cooking, and enjoyed an increase in business. Gamma Grill extended restaurant hours to include breakfast, and to offer late-night snacks from the wood-fired grill. The owners of Gamma Grill had not realized that wood is a "fuel," and have not provided notice or any information to Pento Properties.

This scenario could lead to impacts such as those described below.

- Pento Property's air pollution control system is not equipped to remove ash from burning wood. The regulatory agency fines Pento Properties for violations of air emissions regulations.



- Patrons begin finding their cars covered with ash after shopping at Mega Mall. The patrons incur costs for washing vehicles. Some patrons become convinced that the wood ash has damaged the paint on their cars, and demand reimbursement for car repainting and loaner vehicles while their cars are being serviced.
- Patrons stop coming to Mega Mall to shop at other stores, because they do not like their vehicles being covered in ash while they are shopping.
- Teachers at a nearby school notice that students have begun coughing more than usual. Some of the students' parents are having their cars repainted as a result of the ash coming from Mega Mall, and believe that Pento Properties is responsible for their children's illness.



Each scenario has arisen innocently enough, with the owner of Gamma Grill eagerly expanding the restaurant's offerings to grow the business. Lack of knowledge that wood is considered a "fuel" has not avoided the potential impact of this scenario. Pento Properties has at least one remedy – to evict Gamma Grill. This remedy, however, will probably not cover the costs of repainting automobiles and loss of business. Furthermore, the power of social media can lead to reputational damage, as teachers, students, and their

parents make negative comments about Mega Mall and/or Pento Properties. Pento Properties may become embroiled in legal actions that take years and substantial resources to resolve.

EHS Auditing skills could be beneficial in:

- Identifying contractual provisions that apply to EHS matters
- Linking these provisions to current and potential operations
- Establishing a reasonable system of reporting and oversight of EHS-related issues
- Offering training to tenants and stakeholders
- Reviewing tenant restaurant EHS-related reports
- Periodically monitoring the landlord/tenant approach EHS management

EHS Auditing skills as applied to contracts are useful to all parties – the landlord, tenant restaurants, and stakeholders. They are arguably most worthwhile to the entity that has the most to lose – Pento Properties. Pento would benefit from having a professional EHS auditing resource on their team from the outset.



Scenario 3: Customer Requirements: Supply Chain

Toptown Toys is a large manufacturer, and is in the top six companies in their key product areas. Toptown's management has a goal of being in the top three suppliers to Gizmo Recreational Products, a fast-growing manufacturer of popular electronic products. Toptown's Sales team learns that they can sign a Preferred Supplier Agreement (PSA) with Gizmo and increase their chances of sales. Toptown's Sales team eagerly signs the PSA.

The PSA includes a provision that Toptown will comply with the Recreational Products Industry (RPI) Code of Conduct. The Code of Conduct requires companies to develop programs on five environmental parameters, establish of environmental protection goals, compile reports and submit them to RPI members on request, and to submit to RPI audits at the supplier's (Toptown's) expense.

In this scenario, one functional group (Sales) has made a contractual commitment that includes environmental matters without realizing it. Few, if any, people at Toptown may know what conformance with the RPI code of conduct entails.

Industry codes of conduct may address issues that go beyond regulatory compliance, such as inventory and reduction of greenhouse gas (GHG) emissions, reducing the water footprint of their operations, or using recycled materials in product packaging. The process for assessing the impact of new laws and regulations, and assigning resources for compliance is relatively mature. Companies have been doing this since the dawn of environmental regulations in the 1970s. There may be no systems, controls, or resources to address obligations that originate outside this channel. Resource constraints often result in diffuse responsibilities, with the activities that are performed done by committed individuals in their spare time, and with little support from their own management. If data is available, it is of inconsistent quality and may not be usable.



Failure to adequately fulfill contractual requirements can have impacts such as those listed below.

- Gizmo may require Toptown to procure an audit. Toptown incurs costs it was not expecting. The audit identifies many findings, and the auditor rates many of them as "critical."
- If Toptown provides incomplete reports, or reports that show poor performance, then Gizmo may escalate this matter to their Sourcing Team. Gizmo may place Toptown on probation, limiting purchases until Toptown shows substantial progress. This could also apply to other divisions of Toptown, regardless of whether those divisions agreed to abide by the RPI Code of Conduct.



- Toptown has one facility in Cortasia that excels at all the components of the Code of Conduct. This has been achieved by an influential, fiercely dedicated local employee without support or resources provided by facility or corporate management. Toptown could submit a report for the Cortasia facility only and fulfill the requirement of the PSA, and substantially increase production at the Cortasia facility. However, with no roles, responsibilities, or mechanism for internal reporting and communications on voluntary EHS matters, none of Toptown's Gizmo-facing management is able to report on these achievements. Toptown drops out of the PSA, and loses sales to Gizmo.

EHS Audits are beneficial to Toptown and Gizmo. Toptown would have benefited from an early gap assessment, development of action plans, monitoring performance with action plans, and audit readiness self-assessment for the audit required by Gizmo. Qualified, experienced EHS auditors can provide support with reasonable scopes of work, assessments, and professional guidance during the contractual process.

Gizmo is already using EHS Audits to assess and monitor suppliers' conformance with the RPI Code of Conduct. Gizmo could also benefit from earlier assessments to avoid escalating foreseeable matters to their management, disruption to their supply chain, or their own ability to demonstrate conformance with the RPI Code of Conduct.



4.0 CONTRACT LIFE CYCLE & EHS AUDITOR VALUE

The scenarios above are just a few examples of the diversity and complexity of EHS provisions in contracts. They also illustrate the breadth and extent of potential impact to an organization for non-conformance. One way to reduce the likelihood of any such impact is by using standard compliance, risk management, governance, and auditing principles throughout the life cycle of a contract.

EHS Applicability Through the Contract Life Cycle

Experienced EHS Auditing skills provide value to organizations involved in contracts; with the way business is done today, this is everyone. There can be value in engaging an experienced, independent resource to maintain continuity throughout the life cycle of a contract. EHS risks can be identified, managed, and monitored throughout the life cycle of a contract.

Proposed contract: a qualified specialist can review contract terms for provisions that apply to EHS issues explicitly, or that could incorporate them by reference to broader requirements (such as the code of conduct example described above). The specialist can help assess an entity's ability to conform, or resources that could be required to conform to these provisions.

Contract launch: After a contract is signed, the specialist can develop management systems and controls to ensure conformance with contract requirements, and to demonstrate conformance with requirements.

Contract management: The specialist can help ensure that the entity fulfills EHS provisions of the contract. Incidentally, "risk" does not only involve a possible loss. It may also involve the failure of a party to recover costs from other parties, or to gain competitive advantage from EHS performance.

Contract closure: At the close of a contract, a specialist can help an entity make the most of EHS provisions, and avoid incurring future costs related to EHS matters.



Different Requirements for Contract Support

Auditing EHS provisions of a contract differs from traditional environmental compliance audits in many respects, including those listed below.



- **The criteria:** Regulatory compliance may not be the criteria, or it may be only a part of the criteria. Traditional environmental compliance audits use regulatory requirements as the audit criteria. For audits to contracts, the audit criteria must be customized from the contractual provisions and other applicable criteria.
- **Business drivers and audit resources:** Environmental compliance audits may be done by in-house environmental auditors, external resources, or a blend of the two. Audits to contracts could result in an entity escalating business matters or a claim against another entity. In-house auditors often have full-time responsibilities for ongoing operations and compliance, and may not have sufficient or appropriate resources to meet the organization's needs.
- **Enterprise Risk Potential:** The scenarios above illustrated the potential extent and impact of unintended consequences: costs for long-term site clean-ups; loss of customers; reputation impairment; or inability to meet business goals.



- **Reporting and communications:** Reporting channels may differ from traditional environmental compliance audits. EHS management activities can require reporting to entities external to the organizations (tenant to landlord, buyer to seller, etc.). The same can be for audits tailored to the EHS provisions of the contract.

Resources for a Successful Outcome

Proficient management of these issues requires a broad and diverse set of skills and experience. In addition to experience in compliance, risk management, auditing and governance, a resource (or resource team) should have experience in:

- Regulatory framework for EHS laws and regulations
- Applicable contracts (transactions, supply chain agreements, lease agreements, etc.) and the business implications of those contracts
- Different types of audits, including their advantages and limitations
- Developing customized audit criteria, and performing audits to those criteria

The resource/ team must also have proficiency for verbal and written communications and reporting. In-house resources may not have sufficient breadth of experience. Furthermore, in-house resources usually have “day jobs” and may not have sufficient time to devote to longer-term, strategic, risk-based thinking. An external resource can ensure organizational focus, and often pays for itself in a short time.

Credentials from a respected entity can help provide confidence in the proficiency of a resource. The Board of EHS Auditor Certifications (BEAC) created the Certified Professional Environmental Auditor (CPEA) credential, with focus areas including environmental compliance, safety compliance, and



management systems. The Institute of Internal Auditors (IIA) assumed BEAC in early 2016², and now administers the CPEA program.

The IIA itself is a global organization with more than 180,000 members. Established in 1941, the IIA has 160 chapters in North America serving over 70,000 members. The IIA offers credentials including the Certified Internal Auditor (CIA), Certified Risk Management Assurance (CRMA) professional, and Certification in Control Self-Assessment.

Organizations would do well to monitor EHS requirements and risks included in any business contract. They would also do well to influence EHS terms and conditions in contracts they initiate. The support of resources with suitable experience and credentials can help reduce risks and leverage opportunities from these contractual provisions.

² See <https://na.theiia.org/certification/beac/Pages/Get-Started.aspx>



ABOUT THE AUTHOR



Douglas Hileman, CRMA, CPEA, P.E. has led his own firm for over seven years. He draws from over 35 years of experience in many aspects of operations, compliance, business strategy, enterprise risk management, non-financial reporting, audit readiness, and auditing. He worked at PricewaterhouseCoopers for six years, where he supported financial audits, internal audits, and other engagements involving governance, risk management, compliance. He also has nine years of experience in industry.

Douglas has supported dozens of transactions, working for parties involved in mergers, acquisitions, divestitures, joint venture agreements, and other service agreements. He has helped clients draft contract provisions, design and implement management systems for contract terms, and monitored conformance with contract terms. He has conducted reviews in support of insurance policies.

Doug has experience in many aspects of non-financial reporting (also referred to as Sustainability or Corporate Responsibility). He has written Sustainability reports, and conducted sustainability program assessments. He has supported clients' efforts related to customer requirements and industry codes of conduct. He is a leading expert in the field of conflict minerals; his firm conducted two of ten Independent Private Sector Audits (IPSAs) submitted voluntarily to the SEC for the first two years of the SEC's conflict minerals rule. He developed a website for professionals interested in this matter.

He is active in the Institute of Internal Auditors. He holds credentials as a Certified Risk Management Assurance professional (CRMA), Certified Professional Environmental/ Health & Safety Auditor (CPEA, Management Systems focus), and a Professional Engineer (chemical). He has taught "Incorporating Sustainability into Financial Reporting" at UCLA Extension. His firm serves clients nationwide from Los Angeles.

See www.DFCMAudit.com for more resources on conflict minerals.

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