

I N S I D E   T H E   M I N D S

# The Impact of Environmental Issues on Business Transactions

*Leading Lawyers on Managing Environmental  
Regulation and Enforcement for Businesses*



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The Future of  
Environmental Regulation and  
the Impact on the Practice  
of Environmental Law

Michael D. Klein

*Member*

Cozen O'Connor



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## **Introduction**

Over the last several years, attorneys have begun to see the focus of environmental regulations in the United States shifting from cleaning up legacy contamination to anticipating the environmental challenges of the future. Specifically, the vanguard of environmental law is dealing with issues associated with a changing climate, the most pressing challenges being those associated with energy production. While the regulation of greenhouse gas emissions dominated the dialogue early on, regulations affecting the use of the nation's limited water resources are arguably more important and have the potential to more significantly impact business in the United States. Critically, the law governing air and water is rapidly changing as climate policy is developed and implemented at the federal, state, and local levels. These changes can lead to regulatory uncertainty that can materially affect business transactions. To prepare for the challenges associated with a regulatory climate in flux, companies must stay aware of legal developments at all levels of government and ensure they have implemented an adaptable compliance program that can account for new and changing regulatory requirements.

## **Finding Certainty in the Face of Environmental Regulatory Complexity in the United States**

Complaints of an increasingly heavy regulatory burden seem to be universal among US companies today, particularly in light of the domestic and global financial situation. Because the United States has relatively robust environmental regulatory programs at the state and federal levels addressing air, water, and toxic and hazardous materials, many such complaints from US companies have been directed toward state and federal environmental regulators. While recognizing the importance of both preserving the significant progress that has been made in the last forty years with respect to cleaning up the historic contamination and further enhancing the health of the environment through ongoing public and private initiatives, many companies have become concerned that the benefits to the environment of increased regulation are rapidly being outweighed by the ensuing impacts on the economic health of the country.

It is true that environmental regulations can and do present a regulatory burden in terms of both costs and complexity. But, while the significance of

costs associated with achieving regulatory compliance will vary by industry, a good lawyer should be able to work with clients to help identify least-cost compliance options through creative legal solutions, minimizing the burden imposed, and possibly enhancing the company's bottom line. Determining the potential financial impact of environmental regulations on a company's operations, and the appropriate business strategy in response, should be a fairly straightforward exercise.

However, it is the relative complexity of the various legal regimes currently applicable to US companies that presents an element of uncertainty that is hard to monetize, and determining the impact on a company's bottom line becomes more difficult. For example, and as discussed later in this chapter, new regulations are being drafted to address climate change-related issues, throwing traditional regulatory expectations into flux. But regulatory complexity arises not only from the numerous standards, work practices, and other requirements, which present a general compliance issue, but within the maze of permitting and approval processes that apply to projects at the federal, state, and local levels. Moreover, within this context of the environmental permitting process, already a challenging field to navigate, legal uncertainty provides new opportunities for third-party challenges to projects, both at the agency level and through judicial appeals, that may at best delay a project, but may also result in onerous and expensive conditions, substantial modifications, or outright rejection of a project. While "background levels" of permitting uncertainty have always been present to a certain degree, the persistence of the economic downturn has only amplified the issue, making it a much more important consideration when considering the overall project.

As regulatory uncertainty increases, it becomes all the more important for companies to develop strong internal audit programs and environmental management systems to manage the associated business risks. A general lack of regulatory certainty only serves to stymie investment in new businesses or the expansion of existing company operations. The economic downturn also means both that fines and penalties for noncompliance will have a greater proportional impact on a company's bottom line and that regulators will be stepping up enforcement of existing regulations, which

has the potential to help offset a decline in government revenues.<sup>1</sup> As a result, companies must conduct regular audits and implement best management practices to ensure their compliance programs are up to date. This will help companies avoid enforcement actions, mount an effective defense in the event an action is brought, or otherwise manage risk so investment decisions can be made with confidence.

## **Climate Change as a Driver of Future Clean Water Initiatives**

The primary driver of many of the most recent environmental regulations clearly should be on the radar of US businesses—climate change. Whether climate change is caused by human activities is beside the point. Regulations premised on slowing or ameliorating the effects of shifting climate patterns are here to stay. State and federal regulation of greenhouse gas emissions, which include everything from monitoring and reporting requirements<sup>2</sup> to emissions performance standards,<sup>3</sup> have received the lion's share of attention over the last several years. However, state and federal regulation of greenhouse gas emissions from US companies, while potentially expensive, will not have a direct impact on the vast majority of companies in the country. Rather, the effects of climate change—variable, more extreme, and generally less predictable weather events—will not only act as regulatory drivers, but have the potential to directly impact US business by affecting insurance coverage, the availability of natural resources, and shifting regional demands for energy, products, and services, among others. It will be important for companies and their legal counsel to anticipate how laws and regulations will be adopted in response to these anticipated weather extremes.

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<sup>1</sup> Environmental agency budgets in particular have experienced significant declines in recent years. See ENVTL. COUNCIL OF THE STATES, STATUS OF STATE ENVTL. AGENCY BUDGETS, (2011–13) available at <https://dl.dropbox.com/u/8005220/September%202012%20Green%20Report.pdf>.

<sup>2</sup> E.g., Mandatory Reporting of Greenhouse Gases, 74 Fed. Reg. 56,260 (Oct. 30, 2009) (to be codified at scattered sections of 40 C.F.R.)

<sup>3</sup> E.g., Standards of Performance for Greenhouse Gas Emissions for New Stationary Sources: Electric Utility Generating Units (Proposed), 77 Fed. Reg. 22,392 (Apr. 13, 2012).

*The Unique Importance of Water*

Water regulations in particular will be extremely important to stay abreast of in the coming decades. Clean water is a finite resource that is not only critical to maintaining public health, but is also essential to major industries in the United States, including farming, energy production, manufacturing, and the public drinking water supply. With respect to energy, water supply and power production are uniquely intertwined. It takes significant amounts of energy to pump water from surface and groundwater supplies, to treat it, and to move it throughout water distribution systems. Likewise, it takes significant amounts of clean water to support energy production, in both the resource extraction and generation sectors. For example, high volumes of water are used in oil and gas production, particularly in the development of shale gas through the practice of hydraulic fracturing. Large amounts of water are used to wash and transport coal. At power generation facilities, water is used both to power steam-driven turbines and to cool them. Clearly, the water-power nexus is also a critical intersection of potentially divergent climate policies.

Problems associated with water, as with all natural resources, can be summed up in two words: quality and quantity. Even without amplification by climate-related concerns, each can have a material impact on businesses operating in the United States. Water quality regulations, implemented to protect, maintain, and improve the quality of water, can have a direct impact on business in the form of effluent pre-treatment requirements, the purchase and installation of pollution control equipment, and the cost of monitoring, recordkeeping, and reporting, among other things. And the regulation and allocation of water rights and the timing of permitted water withdrawals will clearly impact businesses that depend on large volumes of water. At the same time, it is important to recognize that the impacts of water-related regulations may also be indirect. For example, even where a particular business may not be affected directly by water quality or quantity issues, it may be indirectly impacted when upstream suppliers pass along the costs associated with compliance in the form of more expensive commodities, supplies, components, and power.

As a result, any business transaction in a water-intensive industry must consider the impacts of current and future water quality and availability. It is important to conduct full environmental due diligence, including gaining a firm understanding of existing water rights and compliance with water quality regulations, ahead of any major transaction involving the purchase and sale of assets or operations. This applies both to buyers and to sellers. Although the parties can shift the onus of environmental liabilities through contract negotiations, this is only an effective tool with respect to known liabilities. Buyers can strengthen their position by having a full grasp of the status of current and historic environmental compliance, which should provide insight on potential future compliance issues. Failure to anticipate and prepare for the potential impacts of increasingly stringent water regulations on the future performance of a going concern can result in fines and penalties for noncompliance and increased operating costs—or worse, constrict a company’s ability to grow and expand. Sellers can also gain a better position in sales negotiations by anticipating the buyer’s concerns and coming to the table prepared.

#### *Location and Use as Key Considerations*

How various businesses may be impacted depends entirely on location and how water is used. With respect to location, every state has a different legal regime governing water rights, which should be a major consideration for any water-intensive company looking to locate a new facility or expand existing operations. The basic doctrines include the natural flow doctrine, the reasonable use doctrine, and the prior appropriation doctrine. In short, under the natural flow doctrine, the riparian landowner has a right to the same quality and quantity of water as it would occur naturally—no other use that would affect the natural flow is allowed. Under the reasonable use doctrine, the water rights of riparian landowners are subject to any “reasonable” use of the water by upstream users. Finally, the doctrine of prior appropriation provides that the user who is first in time has the right to use the water in whatever way he or she chooses. While these doctrines have been modified over the years by the statutory, regulatory, and case law in each jurisdiction that has applied them, the relevant factors invariably include the location of property with respect to a body of water and the use to which the water is to be put.

Early in the country's history, the Northeast was at the center of industrial development due, in part, to its large population centers, but also due to the abundance of natural resources such as water. The dominant doctrines governing water rights are the natural flow and reasonable use doctrines. Over time, however, as the resources diminished through overuse or pollution, government responded with increasingly stringent regulations that greatly increased the cost of doing business. As a result, many businesses moved westward into the Sunbelt, where regulations were more lenient and costs were lower. However, certain key resources such as water are not as abundant in the South and Southwest as they are in the Northeast. The doctrine of prior appropriation is widely applied, which constricts the growth of water-intensive operations, and environmental regulations (and the associated costs) have begun to catch up in what were traditionally under-regulated states. Accordingly, it appears that there has been a new shift in development back toward the East Coast.

That being said, increased population densities and intensification of water use have increasingly stressed water supplies across the country. Combined with the volatile weather frequently attributed to climate change, this has forced both companies and regulators to seriously reassess how water supplies are managed and allocated. For example, due to drought conditions in Pennsylvania in 2012, stream flows in the Susquehanna Basin dropped to such low levels that the Susquehanna River Basin Commission (SRBC), which is a federal-interstate compact commission with regulatory authority over water management and allocation in the basin, had to temporarily suspend permitted water withdrawals on several occasions by natural gas producers operating in the Marcellus Shale, among other users.<sup>4</sup> In addition, the SRBC recently proposed a new low flow protection policy to enhance protection and prevent significant adverse impacts to the water resources of the basin.<sup>5</sup> Water utilities in particular must be alert to the effects of climate change on projected water supplies over the long term.

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<sup>4</sup> See, e.g., News Release, Susquehanna River Basin Comm'n (SRBC), 64 Water Withdrawals for Natural Gas Drilling and Other Uses Suspended to Protect Streams (July 16, 2012) available at [www.srbc.net/newsroom/NewsRelease.aspx?NewsReleaseID=90](http://www.srbc.net/newsroom/NewsRelease.aspx?NewsReleaseID=90).

<sup>5</sup> SRBC, PROPOSED LOW FLOW PROTECTION POLICY RELATED TO WITHDRAWAL APPROVALS (2012) available at [http://www.srbc.net/policies/docs/LowFlowProtectionPolicy\\_20120313\\_fs139580\\_1.pdf](http://www.srbc.net/policies/docs/LowFlowProtectionPolicy_20120313_fs139580_1.pdf).

The impacts of climate change with respect to water source temperature may also become an important consideration for businesses over the next several years. For example, a nuclear facility in Connecticut had to shut down one of its generation units temporarily in August 2012 because the water source it relied on for cooling was too warm.<sup>6</sup> Between warming waters, hotter ambient air temperatures, and decreased annual rainfall, power plant operators, manufacturers, and others may be facing a wide variety of operational challenges resulting from environmental conditions that will require significant capital expenditures, even without taking new regulatory requirements into account.

Another important consideration flows from the fact that many programs under the Clean Water Act<sup>7</sup> and most under the Safe Drinking Water Act,<sup>8</sup> including permitting and enforcement, and other regulatory responsibilities, may or may not have been delegated to the states. For example, administrative oversight of National Pollution Discharge Elimination System permits under Section 402 of the CWA<sup>9</sup> has been largely delegated to the states under Environmental Protection Agency-approved implementing programs.<sup>10</sup> Oversight of pretreatment requirements and sludge management programs also may have been delegated. To qualify for delegation, states typically are required to adopt programs at least as stringent as the federal program; however, states are often given license to set standards, work practices, record-keeping, and reporting requirements that are more onerous. Some states may also have programs that run in tandem with the federal regimes, filling gaps in the federal program, or which may be applicable to entirely intrastate activities not subject to federal control. The basic issue is one of regulatory consistency and predictability, and companies must be aware of the unique nuances in regulatory application as between jurisdictions.

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<sup>6</sup> Joseph Eaton, *Record Warm Water in Long Island Sound Shuts Down Connecticut Nuclear Power Plant*, NAT'L GEOGRAPHIC (Aug. 13, 2012) available at [www.greatenergychallengeblog.com/2012/08/13/record-warm-water-in-long-island-sound-shuts-down-connecticut-nuclear-power-plant](http://www.greatenergychallengeblog.com/2012/08/13/record-warm-water-in-long-island-sound-shuts-down-connecticut-nuclear-power-plant).

<sup>7</sup> Clean Water Act, 33 U.S.C. §§ 1251-387 (1972)(amended 1987).

<sup>8</sup> Safe Drinking Water Act, 42 U.S.C. §§ 300f-j (1974).

<sup>9</sup> 33 U.S.C. § 1342.

<sup>10</sup> State Delegations—Clean Water Act, ENVTL COUNCIL OF THE STATES (ECOS) [www.ecos.org/section/states/enviro\\_actlist/states\\_enviro\\_actlist\\_cwa](http://www.ecos.org/section/states/enviro_actlist/states_enviro_actlist_cwa).

## **Opportunities Posed by Changing Environmental Regulations**

While increasing regulatory complexity can result in significant costs for many businesses, companies that can effectively anticipate the regulatory trends being driven by climate change will be well positioned to take advantage of equally significant business opportunities. For example, water reuse, which involves treating municipal and industrial effluent and storm water for reuse, is becoming an increasingly hot topic. With advances in treatment technology, more regulators are adopting requirements for water reclamation and recycling. While more commonly employed at centralized treatment facilities, an increasing number of jurisdictions are turning to onsite gray water recycling as a way to conserve fresh water resources. The concept of “zero discharge” is certainly not new, but the development of zero discharge facilities is becoming increasingly common. Companies that are at the forefront of developing water recycling technologies that meet customer needs and can effectively meet or exceed the standards set by regulators stand to gain significantly.

As the public becomes more aware and sensitive to environmental issues, new laws are being enacted at the state and local level to encourage full disclosure of energy and resource efficiency as a way to promote more environmentally conscious businesses. In Pennsylvania, for example, Philadelphia recently enacted an ordinance requiring commercial properties of a certain size to track and make publicly available statistics on annual energy and water consumption. The ordinance applies to commercial properties with indoor floor space of 50,000 square feet or more. Other cities, such as Austin, New York, San Francisco, and Seattle, have enacted similar laws. Developers of commercial real estate can take advantage of this trend by increasing the efficiency of their buildings and actively marketing their green profile to environmentally conscious businesses. A number of companies are either developing technologies that will directly enable significant gains in efficiency or are helping large businesses become more sustainable by identifying opportunities for company-wide efficiency gains. The greater emphasis on resource efficiency and environmental sensitivity has also created more business opportunities in general in the fields of large- and small-scale wind and solar power generation and other renewables.

Nutrient trading is also a relatively new market-based concept that is just starting to come into its own. For example, Indiana, Kentucky, and Ohio recently launched a pilot program, the Ohio River Basin Water Quality Trading Project, designed to reduce water pollution in the Ohio River. With nutrient trading, a total maximum daily load (i.e., a “cap”) is established for a given water body, and market participants such as industrial facilities and farmers trade “credits” that are generated from pollution reduction activities in order to meet their respective permit limits. Much work is needed to ensure that these programs are able to create genuine gains in water quality, but they are beginning to catch on. Potentially lucrative opportunities may be available for ground-floor participants and other early adopters who are able to take advantage of low-cost reductions by adopting alternative waste management practices or installing pollution control technology.

### **Developing an Effective Environmental Compliance Program**

To ensure compliance can be achieved in the face of increasingly complex environmental laws, companies must have in place dynamic environmental compliance programs that are thorough and can adapt quickly to new changes in applicable law. Lawyers have a duty to keep their clients informed of the latest trends in environmental regulation and to help them anticipate the challenges they will pose to operations. Accordingly, environmental lawyers should track the key legal requirements that apply to their clients and take a lead role in working with company personnel familiar with facility operations to create and oversee a company’s internal environmental audit programs and environmental management system and ensure they are up to date.

Designing an effective compliance program also requires an understanding of the consequences of noncompliance. As such, lawyers must be aware of the criminal and civil fines and penalties under the state and federal environmental law statutes applicable to their clients so they can render advice on the potential spectrum of governmental responses. However, lawyers must also be knowledgeable on law providing for citizen suits and natural resource damage claims, which open a potential avenue for private

suits, even where, strictly speaking, certain polluting activities may not constitute a regulatory violation.<sup>11</sup> Knowing the full range of risks associated with a failure to comply with one law as opposed to another will help clients prioritize their compliance efforts.

At a minimum, compliance programs should be designed to ensure that a company is in full compliance with its environmental permits. The Environmental Protection Agency (EPA) provides sample audit protocols for the major federal environmental laws that should be referenced when designing any compliance program.<sup>12</sup> An ideal program would not only assess the compliance status of company operations, but would allow the company to identify compliance strengths and weaknesses, and to compare current practices against industry and regulatory trends so that best management practices can be timely identified and implemented. Formal compliance training modules should be developed for employees and made mandatory for all new hires. “Refresher” courses should also be held on an annual basis.

Once an environmental compliance program has been established, legal counsel should participate in a regular legal review of programs and related policies to ensure the client flags all policies potentially affected by changes in the law, and should work with the client to design cost-effective compliance strategies. A regulatory index or other internal reference system should be incorporated into company policies so that operations affected by regulatory changes can be quickly identified. The timing of compliance program updates should correspond with the applicability of new legal requirements, taking into consideration adequate planning horizons for necessary training and any potential gains as an early adopter, so that all operations are prepared to comply on day one. Maintaining good records is also essential to this process. All records should be maintained as required

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<sup>11</sup> Note that compliance with federal law may serve as a defense against certain types of suits. For instance, the courts have ruled that the federal Clean Water, Clean Air, and Safe Drinking Water Acts preempt federal common law public nuisance suits. *Milwaukee v. Illinois & Michigan*, 451 U.S. 304 (1981) (CWA); *Am. Elec. Power Co., Inc. v. Connecticut*, 131 S.Ct. 2527 (2011) (CAA); *Mattoon v. City of Pittsfield*, 980 F. 2d 1 (1st Cir. 1992) (SDWA).

<sup>12</sup> *Audit Policies and Guidance*, EPA, available at <http://cfpub.epa.gov/compliance/resources/policies/incentives/auditing>.

by law, though every company should develop a consistent document retention and destruction policy. Good record-keeping is important both to maintaining and demonstrating compliance with environmental regulations, as well as for establishing defenses.

The EPA and many states have developed audit policies that encourage companies to develop systematic self-audit regimes and to self-report any instances of noncompliance. These policies provide penalty relief when a company identifies noncompliance through a qualifying self-audit program and self-reports to the appropriate authority. For example, the EPA's audit policy<sup>13</sup> contains nine conditions that must be met in order to qualify for the policy incentives, including relief from gravity-based penalties. These conditions provide that the identification of noncompliance must be made through a systematic and voluntary discovery process that is independently discovered and disclosed to the EPA within twenty-one days. The company must also take measures to remediate the noncompliance and prevent its recurrence. Companies should have their compliance programs reviewed by their attorney specifically to ensure they can meet the conditions of the EPA's audit policy (and any applicable state policies).

However, companies also need to be prepared to conduct a timely, detailed compliance audit when acquiring a new business or assets. It is not enough to rely on a transfer of liability provision in the deal documents and, in light of time constraints and typically limited access to records, it is rare that pre-acquisition due diligence will result in comprehensive discovery of potential noncompliance. In performing more thorough post-acquisition audits, benefits similar to the audit policies above may be available. The EPA, for example, has an "interim" approach to applying its audit policy to owners of recently acquired facilities that relaxes certain of the nine conditions of the standard audit policy, and provides expanded penalty relief in connection with disclosed violations. For example, where a pre-acquisition audit uncovers instances of potential noncompliance, the EPA will waive the requirement that such audits be "periodic." Importantly, all potential

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<sup>13</sup> U.S. EPA, Incentives for Self-Policing: Discovery, Disclosure, Correction, and Prevention of Violations, 65 Fed. Reg. 19,618 (Apr. 11, 2000), *available at* [www.epa.gov/oecaerth/resources/policies/incentives/auditing/auditpolicy51100.pdf](http://www.epa.gov/oecaerth/resources/policies/incentives/auditing/auditpolicy51100.pdf).

violations, even those that would have been discovered by a mandated monitoring, sampling, or audit protocol, are eligible for penalty relief.

## **Outlook on Climate Change**

Only a few short years ago, federal legislation to create a comprehensive national response to climate change was a major focus in US politics. However, it has since been relegated to the backburner in light of the ongoing financial crisis, and the political will to enact such legislation may not return for the future. Therefore, to the extent that there are any major advances in climate change-related legislation, it is likely to happen at the state level.

Despite the political lull, companies must not respond by being passive. Indeed, faced with the fact that legislative efforts have effectively stalled, federal agencies are returning to their mandates in existing environmental laws to see how their authority can be reinterpreted to include responses to challenges of a changing climate. For example, even in the absence of federal legislation specifically directing the EPA to take action with respect to climate change, the US Supreme Court determined that the EPA has the authority under the Clean Air Act<sup>14</sup> to regulate emissions of greenhouse gas as a “pollutant.”<sup>15</sup>

It will be important for any business that may be impacted by climate legislation, particularly those in the energy sector and other carbon- and water-intensive industries, to monitor federal and applicable state legislation closely. While many companies are already required to track greenhouse gas emissions, even if a company is not currently subject to greenhouse gas regulation, it should nevertheless develop a basic understanding of its emissions profile, including that of its upstream suppliers and downstream customers. The same advice applies to companies with respect to water. They must be acutely aware of their own water use, as well as that of their various suppliers and customers. This will allow companies to participate meaningfully in the event that regulations affecting them are proposed, and

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<sup>14</sup> Clean Air Act, Pub. L. No. 88-206, 77 Stat. 392 (1963) (codified as amended beginning at 42 U.S.C. § 7401).

<sup>15</sup> *Massachusetts v. EPA*, 549 U.S. 497 (2007).

will help them determine how proposed legislation/regulation affecting other industries may nevertheless impact them indirectly.

## **Conclusion**

Climate change-related concerns have become a leading driver of regulatory developments in the twenty-first century. While regulations addressing emissions of greenhouse gas and designed to slow or stop global climate change tend to take center stage, these are less important to the majority of US companies. Instead, it will be laws associated with water quality, use, and allocation that will have the greatest impact on companies in the coming years. In light of a rapidly evolving and increasingly sophisticated regulatory landscape, it is more important than ever for businesses of all sizes to review and evaluate the impact of water on their operations and to develop effective environmental compliance programs that can quickly adjust to new requirements.

To guide companies through these processes, lawyers will need to keep abreast of the latest legal trends affecting water and help their clients anticipate the effects of new regulations on long-term business projections and identify ways these new regulations place the relative water security of their operations in jeopardy. In addition to traditional continuing legal education, lawyers should stay actively engaged with the associations and other industry groups in which their clients participate so they understand how environmental law issues are being encountered and dealt with on the ground. Armed with this knowledge, environmental lawyers will be in the best position not only to advise their clients on how to manage the risks associated with regulatory complexity, but to take advantage of potential business opportunities as well.

## **Key Takeaways**

- Maintain an awareness of when the company's business model is sensitive to changing environmental regulations, either directly or indirectly.
- Conduct regular audits and maintain best compliance practices to ensure clients are keeping current with all applicable environmental requirements. Keep clients informed of the latest trends in

environmental regulations and help them anticipate the challenges they will pose to their operations.

- Be involved in creating and overseeing a company's internal environmental audit programs and environmental management system. Closely monitor key regulations affecting the client's industry and establish a system to update all compliance programs accordingly.
- Advise clients to develop a consistent document retention and destruction policy. Good record-keeping is important to both maintaining and demonstrating compliance with environmental regulations, as well as for establishing defenses.
- Track the key legal requirements that apply to your clients and correspond with clients regularly regarding changes in the law. Work with the client to design cost-effective compliance strategies, including a training program to ensure employees are aware of new requirements. Provide refresher courses to clients on the key environmental regulations affecting their business.
- Stay actively engaged with the associations and other industry groups in which your clients participate. Make a point of studying current agency policy and guidance, knowing the major case law, and understanding the most recent regulatory trends.

*Michael D. Klein currently practices in the Washington DC, and Harrisburg PA offices of Cozen O'Connor as a member of the Energy, Environmental, and Public Utility Practice. He has extensive experience representing utilities, municipalities, and corporations in the areas of energy, utility, and environmental law, eminent domain, and finance and construction law. He represents clients on wind power projects and on natural gas leasing, primarily involving Marcellus Shale. He handles an array of drinking water, sanitary sewer, and water rights cases and is legal counsel to state chapters of several US and international associations of public water suppliers. He represents clients in litigation, mergers, acquisitions, and public and private financings. He is also active in representing public and private owners in the siting and permitting of drinking water, wastewater, wind power, natural gas, oil, and solid waste disposal facilities.*

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