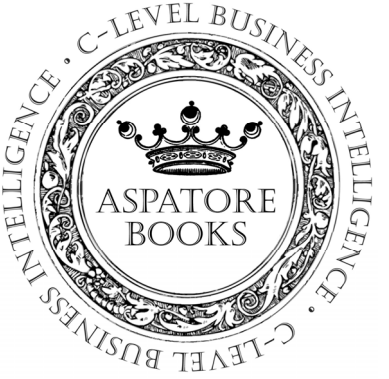
INSIDE THE MINDS

Environmental Law Deal Strategies

Leading Lawyers on Identifying Environmental Liabilities, Structuring Transactions, and Developing a Negotiation Strategy



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Key Questions for Addressing Environmental Issues in a Transaction

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When I am first hired to represent a client on a deal, I start by asking questions. With apologies to any journalists who may be reading this, and to bring some sense of order to the inevitable messiness of due diligence and deal-making, I have organized these questions using the useful, if somewhat hackneyed, "Who, what, when, where, why, and how?" Once I have answers to those questions, I am in a much better position to advise the client on the best way to get the deal done, or, as is occasionally necessary, to avoid the deal altogether. In this chapter, I set out the types of questions I ask the client or the corporate or real estate counsel with whom I am working—the "who, what, when, where, and why"—and certain deal strategies that can get the deal done—the "how."

First and foremost, my role in a transaction is as a member of the team. I think of myself as a deal lawyer who happens to practice environmental law. My role is not to throw up roadblocks and protect the client to the point that they cannot engage in their core business, whatever that might be. My role is to find out the facts, make sure the client understands the facts and the risk associated with them, and negotiate a deal that is favorable to my client.

"Who?" Identifying the Client's Needs

Who is the client? Are they the buyer or seller? Is it a real estate developer or investor? Or a large institutional client selling off unused assets? Will they be redeveloping the property, or using it for its current purposes? If there is an embryonic structure to the deal, has it been decided who will be assuming the environmental risk—buyer or seller? Is the entity assuming the risk a viable entity, or are they a special purpose entity that has no assets other than the underlying real property? Are there institutional investors involved who have different risk profiles or takeovers than the client?

Clearly, the first question is the most important—do I represent the buyer or seller? The answer to that question completely changes how I negotiate the agreement. For example, if I represent the seller, I try to limit the representations and warranties, maybe to the point of making no representations or warranties, while I try to make them as expansive as possible when representing the buyer. However, I find that no matter whom I represent, it is important to find out how much is known about the

site and to have that information provided as early as possible. Most environmental issues are manageable if the buyer is willing to take on at least minimal risk, but information shared at the last minute will at least put off the closing date, and at worst kill a deal.

Is the client a developer who finds that it is worthwhile to take some risks because it is counting on the returns? Or is the client a large, publicly traded company with deep pockets and regulatory reporting obligations? A large company selling property is much more likely to want to control the environmental issues at a site, even post-closing, as past experience has shown that contractual protections alone will not isolate the company from the past. Institutional clients will often have fully investigated a site, and if remediation is required, will either perform it prior to selling or will conduct the remediation itself, post-closing, so as to ensure it is done properly. They will further want to control the future uses of the property to limit future liability. If that work takes place post-closing, the contract must provide that the new owner will allow for limitations on future use.

In contrast, the smaller real estate development or investment company may forego investigations, relying on insurance, indemnities, or escrows in the event that something is later discovered at the property.

"What?" The Nature of the Transaction

What is the client buying or selling? Is this strictly a real estate transaction, or is it a corporate transaction involving an ongoing business? If it is a corporate transaction, is it a stock deal or an asset deal? Will the client be staying in its current location or moving the business? If it is a real estate transaction, is the client buying the real estate, leasing, or investing? What are the environmental conditions? Do we know, or do we have to investigate? Will the seller allow an investigation?

Real estate transactions are simpler. We are generally just concerned about the environmental conditions at the property, although there are some operational issues that arise as well. When talking about the environmental conditions of a property, we are really asking, have there been spills or releases of hazardous materials at the property, or was the property used for the disposal of hazardous materials? The operational issues are similar to

those a property assessment would uncover and provide information necessary to allow the new owner to manage the property properly. Is there a septic system, or does the waste go to the city sewer? Septic systems can be the site of releases of hazardous materials. How is the building heated? If it is heated by oil, are the tanks underground and have they leaked? These are all questions that are readily answered by standard environmental due diligence, known as a Phase I environmental site assessment.[1] Other questions to ask, which may not be answered by a standard Phase I, include: Is there asbestos in the building, and if so, is it in good condition? Does the building have lead-based paint, which is an issue in residential properties and can be an issue for commercial properties if there will be building renovation or demolition resulting in construction debris? Again, the purpose of asking the questions is twofold: first, to allocate responsibility for correcting any deficiencies, and second, to provide the new owner with the information necessary for managing the property going forward.

Corporate transactions are more complex. If the corporate deal includes the acquisition of real estate, one has to ask all the questions discussed above. But a corporate deal also requires an understanding of the business and the other environmental requirements that may apply to the business. What permits are required to conduct the business? Are they about to expire? Have there been past violations of the permits, or of any other applicable environmental law? How does the company store its raw materials and waste materials? Where does the company send its waste material? Have there been any complaints from employees or neighbors about the operations at the facility?

In a corporate transaction, it is critical to know whether it will be a stock purchase or an asset purchase. If one is acquiring the stock of a corporation, one is acquiring all the assets and liabilities, including the

[1] ASTM has standardized the Phase I environmental site assessment, found at ASTM Standard E1527-05. While the ASTM standard could be a subject of its own chapter, for purposes of this chapter, it is important to know that the purpose of the ASTM Phase I environmental site assessment is to meet the definition of "all appropriate inquiry" set forth in the federal Superfund statute, thereby allowing a purchaser of property to prove it has met "all appropriate inquiry" and therefore can claim to be either an innocent purchaser or a bona fide prospective purchaser, avoiding Superfund liability. Unless requested by the user of the Phase I, it does not include information on permitting, on asbestos or lead-based paint, or the applicability of any state statutes.

environmental liabilities. So if the corporation has been named as a potentially responsible party at a Superfund site as a result of historic waste disposal practices, the acquiring entity will acquire that liability as well. This is true even if the company has not yet been named as a potentially responsible party, because the corporation continues to exist and to have the liability. Similarly, liability for failure to have a permit will continue after the acquisition of the stock of the company.

Under traditional corporate law, an asset transaction is different. A buyer acquires only those assets or liabilities it agrees to acquire. However, in many if not all states, courts have adopted a variety of theories whereby those who acquire assets have been held responsible for the past sins of "the business." Successor liability has and will continue to be the subject of court cases, articles, and treatises, but for the purposes of this discussion, it is enough to understand that if one is buying "the business," even if through an asset transaction, the buyer should assume it has the potential to be held liable for the business's past actions. What this means is that the due diligence is just as important as in a stock transaction, and it is even more critical to lay out in as much detail as possible those liabilities the buyer is assuming and those the seller is retaining.

"When?" Building an Appropriate Time Frame

When is the closing? Ok, when is the closing really? How long is the due diligence period? Can it be extended for any reason? When can the buyer get out of the deal for environmental reasons? When can the seller?

In my experience, particularly in corporate transactions, environmental issues are not front burner issues in the transaction—and, unless they are critical to the core business, appropriately so. However, it has also been my experience that not addressing environmental issues until the last minute results in needlessly elevating the importance of issues that were likely resolvable, had the parties had time to learn more about the issues and appropriately evaluate the risks entailed.

Any purchase and sale agreement should set out the parameters of the due diligence period, how long it will be, whether it can be extended and why, and whether and how the buyer can terminate based on the results. When

representing the buyer, I want to make sure the buyer can terminate the agreement "for any reason or no reason at all." If I am representing the seller, I may try to curtail that option—such as allowing termination only when the anticipated costs of remediation exceed a certain amount. I could curtail that option further by requiring the buyer to move forward if the seller is willing to take on liability over a certain amount.

What is often neglected in negotiating such termination provisions is the ability of the seller to terminate an agreement based on due diligence. If the parties have agreed that the seller will be responsible for the environmental conditions, and the due diligence reveals a previously unknown condition or that the cost of remediation would be significant, when representing a seller, I will want the seller to be able to terminate as well. Without such a contingency, a seller could be stuck with the cost of remediation if the buyer goes ahead with the deal.

Due diligence provisions should also address the scope of the due diligence. Will the seller allow invasive testing, such as sampling of soil or groundwater, often referred to as Phase II assessments? Many sellers have investigated their properties and do not want any additional sampling, on the chance that unexpected conditions are discovered. Yet investigations protect the buyer from the unknown. Therefore, if a seller will not allow invasive sampling, I ask for representations that the buyer has been provided all the information known about the environmental conditions at the property, and there are no other adverse conditions. I will also ask for an indemnity for breaches of such a representation and for any liability because of environmental conditions.

Sellers who allow the buyer to conduct Phase II sampling must decide whether they want the results (sometimes ignorance is bliss) or simply want to know whether the deal is going forward. If they are provided the results, I recommend requiring the consultant performing the work to allow the seller to rely on the results. This allows the seller to pursue the consultant for errors, under the contract, just as the buyer would be able to do. Whether they obtain the information or not, sellers should insist on a confidentiality provision, which requires the buyer to keep its information confidential unless otherwise required by law.

Other terms of access, which can either be set forth in the purchase agreement, if it will be signed before due diligence actually starts, or in a separate access agreement, include: notice of the timing and scope of investigation, restoration of the property after the investigation, responsibility of the party conducting the investigation to properly dispose of soil or groundwater generated as a result, insurance and/or indemnity for incidents that occur during the investigation, and confidentiality, as discussed above.

"Where?" Location, Location, Location

Where is the property or company? Different states have certain specific requirements triggered upon sales of businesses or real property, as well as different remediation programs to address contamination. In addition, state law will govern the requirement, if any, to report the environmental conditions discovered during the due diligence period to the appropriate agency. State law will also govern the types of permits required for a particular business or use.

Many states require sellers to notify either buyers or the state agency of the environmental conditions at the property at the time of a conveyance. Each state has its own applicability provisions, as well as specific reporting requirements. It behooves parties to a transaction to make sure they understand the framework within which they are operating, to avoid running afoul of such laws. Local counsel is an obvious resource for such information. Local environmental consultants, who are often conducting the due diligence on behalf of the buyer, are also a good resource.

Similarly, states differ greatly when it comes to the required reporting of environmental conditions discovered during due diligence. Requirements such as these are the reason many sellers do not want buyers to conduct any invasive sampling of a property. The results may trigger reporting to an agency and the subsequent enforcement action for the remediation of the conditions.

Some states require any person with knowledge of a "release" to report it to the state agency, while others only require reporting by the person responsible for the release. Some states require the reporting of the

detection of contamination over certain published criteria. Again, it is important to understand the obligations of reporting before beginning due diligence.

On a more positive note, many states have voluntary remediation programs that allow "innocent" purchasers to conduct remediation and receive a covenant not to sue from the state agency. Such programs can increase the value of the property and eliminate the buyer's concern that it will become liable for environmental conditions on the property simply by being within the chain of title.

"Why?" Defining Client Goals

Why are we here? Why is the client interested in buying or selling the property? What is the client's goal in the transaction? If the client is a real estate investor or developer, is this a long-term investment or will the property be flipped in the near future? Will there be redevelopment or additions to the building? If this is a corporate transaction, are the economics of the overall deal such that the potential costs of the environmental liabilities or issues are not significant? Will the business continue to be conducted from the current location, or will it be moved or consolidated to another location in the near future?

Real estate investors have different strategies. Some purchase underperforming properties that need work, fix them up, and resell them. Others are more interested in the value presented by the current tenants, and their return is the cash flow of the property, rather than the increase in value generated by renovating or improving the property. If the client falls into the first category, we need to understand the potential impact of the environmental conditions at the property on that strategy. Will the environmental conditions result in significant increased costs to renovate the property, or even prevent it altogether? If the client is more like the latter, we need to know who the tenants are and what they might have done to the property.

Obvious potential environmental impediments to renovation are asbestos-containing materials and lead-based paint. Not so obvious impediments include contaminated building materials resulting from past use of the

property. Buildings built before 1981 should generally be assumed to contain asbestos-containing materials and lead-based paint. Asbestos-containing materials are regulated by certain federal laws and regulations, specifically the Clean Air Act and the Occupational Safety and Health Administration's asbestos regulations, as well as state law. In general, asbestos in good condition need not be removed from a building, unless the building will be demolished or the structural members containing or on which the asbestos is located will be removed. However, friable asbestos-containing material (that is, asbestos that is not in good condition) must be removed.

Lead-based paint is generally only an issue for residential properties. The concern is the impact of elevated levels of lead in a child's blood. But lead-based paint can also render construction debris hazardous, depending on the concentrations of lead in the debris. It is generally a good idea to know where and how much lead paint is present to better understand the impact or regulatory status of the waste material.

Similarly, if a building is to be demolished, the potential impact of past uses of the building on the make-up of the construction debris must be determined. For example, transformers that leaked PCB-containing oil result in concrete that may need to be treated as a regulated waste and properly disposed of under the federal Toxic Substances Control Act. PCBs have also been found in paint, particularly in areas subjected to high heat, and the disposal of building materials with such paint may be regulated.

If the value of the property is in the occupants or tenants, the buyer should learn something about the tenants, specifically whether there is anything they have done or are doing that affects the environmental conditions at the property. Does the business handle hazardous materials? Are they being managed properly? Have there been releases? A commercial strip center with a dry cleaner presents a very different risk proposition to a buyer than one without. If the property is industrial in nature, perhaps with a single tenant, is it compliant with all applicable environmental laws? Many environmental laws apply to the "owner" and "operator," and a good buyer or landlord would be well served ensuring that the tenant is complying with applicable laws.

A good Phase I site assessment will involve learning more about the regulatory history of the tenants. It should also include a walk-through of all tenant spaces, to ensure that there are not sloppy housekeeping practices or obvious violations that will become an issue later. The best way to ensure that such issues are the tenant's, and not the landlord's, is a strong environmental section in the lease. Buyers need to review the leases from the point of view of the environmental obligations, as contractual obligations are likely to be stronger and a contract claim is often easier to substantiate than a common law negligence claim or a statutory cost recovery claim, if one is even available.

A lease may be an even more valuable tool when the investor is buying property that was previously sold in a sale-leaseback transaction. In the original sale-leaseback, the buyer had the representations and warranties and any covenants or obligations set forth in the sales agreement, and the ongoing obligations of the lease. When that buyer sells the property again, unless the sales agreement is assignable, the new buyer will only have the protections of the lease, or any new lease it may negotiate. This may be an opportunity to obtain some protections that were not obtained during the sale of the property.

"How?" Creative Strategies, Successful Deals

How can we protect the client? How can we address the environmental issues? How do we get a deal done? These are not mutually exclusive goals. The key is creativity. Set forth below are a few strategies I have used to get a deal done, even when it did not seem possible. These strategies fall into a few categories: due diligence, representations and warranties, covenants, cost allocations, and indemnifications.

For a buyer, the first tool is due diligence. Knowledge is power, and the person who knows more can negotiate a better deal. This means the seller should also know as much as possible about the site before selling it, so parties are on a level playing field when the negotiations begin. The buyer should look at records, have a Phase I site assessment performed even if there is no lender involved, and allow time for a Phase II site assessment if it proves necessary. If there will be renovation or demolition in the near future, consider having an asbestos survey performed. Some of this may be

done pre-contract, but much of it will be done after the contract is signed, during the due diligence period. Therefore, the parties may have already negotiated the allocations of responsibilities and costs. Negotiating in the absence of information can be difficult (for example, with no remediation cost estimate, how do we factor that into the project cost?), but agreements can be structured to make allowances for that. The key is creativity and understanding the parties' objectives.

The seller may hesitate to let a buyer conduct an investigation, because it does not want to obtain unfavorable environmental information and the deal to be terminated for environmental reasons. The buyer does not want to step into an unknown liability. The parties could agree that the buyer can do the investigation, but unless the estimated cost of remediation is more than an agreed-upon amount, the buyer must go forward, and if it is over that amount, the seller has the option of paying the excess over the agreed-upon amount. This serves both parties' objectives—a firmer deal and a fixed exposure.

Due diligence also plays a role in allocating responsibility for site conditions, with the line being drawn at the closing date. It is not uncommon for the parties to divide responsibilities as follows: The seller indemnifies for pre-closing conditions, and the buyer indemnifies for post-closing conditions. If there is no baseline as to the environmental conditions on the property, and the entities are engaged in the same business using the same materials, it is often difficult to know whether a particular condition is a pre-closing or post-closing condition.

Indemnifications can also make or break a deal. As my clients hear from me all the time, an indemnification is only as good as the entity giving it. This is why large institution clients do not like selling property with environmental legacies to developers in return for a transfer of environmental liability—most often the buyer is a single-purpose entity with no assets other than the contaminated property. A solution may be a corporate guaranty, which has more substance. Another solution may be environmental insurance, either cost-cap or third-party liability insurance, which backstops the single-purpose entity's indemnification.

For the sale of a business, is the buyer interested, but highly concerned about being in the chain of title of the underlying property? Perhaps it is a business at which there were historically sloppy business practices, for which the buyer does not want to be responsible? Would a sale of the business assets, but a lease of the real property, satisfy both sides? Restructuring the deal may make it happen.

Does the seller want to avoid the responsibility for the environmental remediation solely for logistical reasons—the facility has shut down, the headquarters are located out of state, but it would just be difficult to get the work done. Does the buyer like the idea of doing the remediation because it has control, can ensure that the remedial work does not interfere with the business, but does not want to have paid the cost? Discounts are useful, but there are concerns. What if the estimate is wrong? The seller loses if the estimate is high, and the buyer loses if it is low. Escrows can avoid this issue. Putting the remediation costs estimate into an escrow allows the buyer to draw down on the escrow to pay the costs, but if there are funds remaining, the seller receives them.

The Bottom Line

There are as many ways of addressing environmental issues in a transaction as there are environmental issues. The key to any of these solutions is in understanding the client, its risk tolerance, and its business objectives. It is also important to understand the other side's goals and motivations, as they will need to buy into any solution as well. Once the client's needs are understood, creativity is necessary for coming up with a solution that can accomplish the client's objectives. Lastly, it is important to remember that occasionally the best way to satisfy the client's objectives is to kill the deal.

Pamela K. Elkow's environmental practice focuses on the voluntary remediation and redevelopment of brownfields; transactional environmental issues; compliance counseling; federal, state, and municipal permitting; and federal and state enforcement. She also works with clients on occupational health and safety issues, in both compliance and enforcement scenarios. Her clients include major corporations, municipalities, and other governmental entities. Ms. Elkow has been involved in a variety of brownfield redevelopment projects for both municipal and private-sector clients. She has also been

involved as environmental counsel on a wide variety of transactions, negotiating environmental provisions of purchase and sale agreements, obtaining and reviewing environmental due diligence, and advising clients on post-closing remediation.

Ms. Elkow is a founder and member of the executive committee of the Connecticut Society of Women Environmental Professionals, an organization for women involved or interested in environmental law, science, business, and policy. She served as co-chair from 1999 through 2003. She is also a member of the executive committee of the Connecticut chapter of the National Brownfields Association. She has spoken and written on a wide variety of environmental issues to diverse audiences. She is a member of the American Bar Association's section on environment, energy, and resources and is a vice chair of its environmental technology and brownfields committee.

Ms. Elkow received her B.A., cum laude, from Colgate University. She received her J.D., with honors, from George Washington University, where she was a member of the Law Review. *She was a recipient of a Connecticut Bar Association 2006 Pro Bono Award. She is admitted to practice in Connecticut, New York, and the District of Columbia.*

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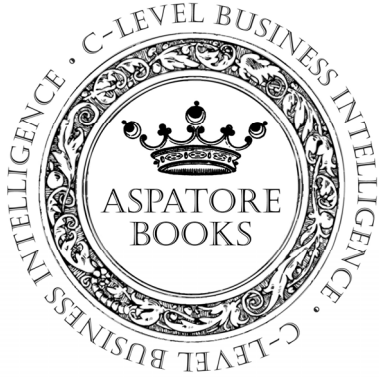
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