NEGOTIATING TRANSACTIONAL ENVIRONMENTAL RISKS

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Introduction

When you are about to strike a business deal you often face environmental unknowns because of unfamiliarity with the venture, party or property involved. At the same time, new and revised environmental regulations which may be applicable are being processed at rates that challenge the best copiers and computers. Though regulations are in flux and sometimes seemingly impenetrable, at least the stream of environmental laws provides a set of rules governing business transactions. Fraud is illegal, of course, and a few states have environmental disclosure statutes, but besides these constraints, parties are limited by only their imaginations and bargaining positions.

Given both the freedom of contract and risk of environmental harm, each party at the outset of a transaction usually proposes a relatively straight-forward document provision: "The other guy shall be responsible for all environmental problems in connection with this agreement from the beginning of Time to the end of the World." Such a proposal has the virtue of simplicity, but usually is unacceptable to the recipient. Thus, the parties usually must decide what should be the breadth and depth of environmental terms.

Their tools for negotiating a mutually-acceptable contract are closing conditions, representations and warranties, covenants and indemnities. Closing conditions simply are conditions precedent, or specified requirements which must be satisfied before a party will perform under a contract. Representations and warranties are factual statements about events or conditions which the maker essentially guarantees to be true. Covenants are promises to take or refrain from specified actions. Indemnitees are a special form of covenant; one party promises to compensate or reimburse another if certain financial or other contingencies occur.

Using these tools to structure environmental risks appropriately depends on the type of deal contemplated. Although certain issues must be addressed whenever negotiating transactional risks, many will vary according to whether the deal is for an acquisition, lease or financing. Accordingly, below we discuss some universal issues and then highlight the most notable concerns from the perspective of the Buyer, Seller, Lessor, Lessee, Lender and Borrower. To more fully illustrate their concerns, we append some sample document provisions. These reflect the range of possible issues, all of which are unlikely to be relevant to any single transaction.

Universal Environmental Issues

Environmental laws generally try to prevent the wrong substance from being in the wrong place at the wrong time in the wrong amount. Many chemicals, substances or materials may be safely used under the right conditions, but otherwise may harm persons, animals or ecosystems. As the use of such materials has increased, so has the number of laws designed to reduce any adverse effects to health and environment. Thus, laws have evolved to control natural resource extraction, sales of products, transportation of hazardous materials, worker and neighborhood exposure to chemicals, emission of air pollutants, discharge of water pollutants and hazardous waste disposal.
These environmental laws may require a business to first obtain governmental approval, engage in certain operating practices or install pollution control equipment. Where, despite such legal requirements, property has become contaminated from current or previous activities, liability is imposed for the clean up and natural resource damage, most notably pursuant to the federal Comprehensive Environmental Response, Compensation and Liability Act *("CERCLA"* or *"Superfund")* or state counterparts.

Environmental Due Diligence

A party to a transaction often will conduct "environmental due diligence" to identify and quantify any compliance or contamination risks. This may range from a relatively quick Phase I environmental site assessment for a multi-unit residential housing financing to exhaustive Phase II assessments and air and water quality studies for an industrial acquisition.

In either case, prudent parties will want to complement any environmental investigation through the terms of the transaction agreements. Closing the deal may be conditioned upon the exchange of due diligence which specifies certain conditions. Representations and warranties may be used to frame environmental conditions by confirming due diligence findings and fleshing out other undiscovered information.

· Covenants may be used to allocate or address response actions and responsibilities for matters disclosed (or undisclosed) by the due diligence process and representations. Indemnities similarly may be used to allocate liability for known and unknown conditions among several parties.

Environmental Laws

An often overlooked initial step to negotiating such provisions is to define carefully the laws and materials of concern. We have reviewed and negotiated countless contracts. While no two have been identical, they virtually all have focused upon two basic concepts: environmental laws and the materials regulated by environmental laws. Yet, while most people share common ideas of what these terms may mean, we have observed many proposed permutations -- including many which were not tailored appropriately for the

parties or properties involved. Pages of environmental provisions and hours of negotiation can be ineffective without the appropriate definitions.
In our experience, most transaction parties have in mind buried drums of chemical wastes or Love Canal when they use the term "environmental law" in a business context. In other words, most people probably think of hazardous waste liability pursuant to CERCLA and perhaps the Resource Conservation and Recovery Act (*"RCRA"*). For many companies, projects and properties, a more significant legal concern may be the ability to construct a road or building in a previously undeveloped area, mine resources from public lands, sell a new chemical product or emit gases from a smokestack. For still others, the biggest liability risks are health injuries from the use of hazardous substances on the job. For some transactions, all of the above matters may be significant. To be comfortable that there has been a meeting of the minds about all environmental business risks, all of these types of laws should be expressly addressed by the relevant contractual documents, which is reflected in the appended sample definition of "Environmental Law".

Hazardous Materials

Similarly, hundreds of different substances are regulated by Environmental Laws and may be termed "hazardous substances", "toxic substances", "hazardous materials", "hazardous wastes" or "special wastes". These usually are defined as such as terms of art for purposes of a single statute. For example, we often see parties define "hazardous substances" as those listed pursuant to CERCLA, perhaps because of concerns about drummed wastes. Nonetheless, major sources of contamination are underground storage tanks (*"USTs"*) which contain petroleum. Because petroleum products are excluded from CERCLA's definition of hazardous substances, leaks from fuel USTs may be outside the scope of numerous terms probably intended to address just such a situation. In addition, any such regulatory list, which may be incorporated in covenants, runs the risk of future elimination. Thus, in many cases it is best to include all types of materials of concern and refer to regulatory lists only for clarification, as in the appended sample definition of "Hazardous Material".

The Buyer

The acquisition of a property or company may bear the most environmental risk of any transaction. Along with the satisfaction of putting another asset to use comes the responsibility of ownership. Regardless of whether the Buyer caused any environmental harm, the Buyer can expect to be burdened with it. The Superfund program may make the new owner of property laced with Hazardous Materials a liable party, event if the contamination was caused by use of the property many years earlier. Even if the Buyer technically is not liable for contamination, as a practical matter, the Buyer may have to take action to avoid publicity, keep the business operating, prevent injuries to others or convince somebody else to buy it.

So that environmental problems can be managed or avoided altogether, it is important to learn as much as possible about the acquisition before the transaction closes. Detailed,

specific representations and warranties, at least at the outset of negotiations, can help accomplish this. They can force disclosure of matters not raised by an environmental assessment.

· There is a difference between a representation and a warranty. A representation is given as to what a person knows or should have known. If a representation is incorrect, there is a breach only if the person knew or should have known the representation was wrong. In contrast, a warranty is stronger; it is a guarantee as to the accuracy of its content. Thus, a warranty is breached when wrong, regardless of the knowledge of the person who gave it.

It is impossible to prepare terms that will be appropriate for every possible scenario, but a comprehensive set of representations and warranties might address the following:

- compliance with Environmental Laws;
- possession of all necessary governmental approvals;
- claims, liabilities and legal proceedings;
- suitability for intended use;
- contamination, pollution;
- release of Hazardous Materials;
- Hazardous Material use and management;
- storage tanks;
- asbestos; and,
- production of environmental records.

The average purchaser probably will want to know why representations cannot be given cleanly about such matters. The appended sample terms contemplate written descriptions for any exceptions.

Post-closing Cleanups

As a consequence of environmental assessments and representations, it is not unusual to discover imperfections at a property which can disrupt the transaction. The safest course is to require any legal violations or contamination to be corrected before completing the transaction. Unfortunately, the technical nature of environmental

problems and frequent participation of regulatory authorities often makes this easier in theory than in practice. Just to excavate contaminated soil may require several rounds of soil sampling and analysis to prepare, which can take months to complete. Ultimately, the parties may proceed with such matters unresolved.
The parties then must agree upon a way to allocate responsibility for such known, pre-existing conditions. The purchase price simply could be reduced to reflect environmental concerns, but then the Buyer must take the risk of estimating remediation costs. To avoid this, the Buyer might insist upon terms similar to the attached sample, which contemplates that the Seller would retain liability for known conditions and pay the costs of any necessary response action. To provide comfort to the Buyer that response actions would not disrupt operations and would not be paid for, the right to control the response would be the Buyer's and the estimated costs would be held back from the transaction proceeds and placed into escrow. To provide comfort to the Seller that response action funds would be used properly, the Seller would have the right to approve the selection of consultants, review response action plans and agree upon escrow disbursements.

Many variations could be imagined, which tend to reflect the specific considerations of any particular property. The variety of site conditions and applicable laws make it difficult to develop a sample provision which will precisely describe in advance the form, scope, substance and depth of an appropriate response and financial disbursement mechanism. Realistically, there is never any risk-free method for handling post-closing response actions and whatever method is chosen will require that the parties be able to work together.

In any event, the Buyer will want an indemnity as to existing site conditions and any third-party claims which may arise on account of such conditions. As in the attached sample, an environmental indemnity may apply to harms arising from an Environmental Law, a Hazardous Material or a breach of representation.

Along with an indemnity for contamination, the Buyer may want a related waiver because of the oddities of CERCLA. This law may make both the Seller and Buyer liable for remedial costs; any such liable parties may have the right to look to the other for contribution of a portion of response costs. This means the Seller who indemnifies the Buyer possibly could turn around and state a claim for contribution from the Buyer. A waiver of contribution as to indemnified claims may prevent this.

The Seller

The principal interest of the Seller is terminating any further liability for the property subject to a transaction. This often is not possible, because the Seller will remain liable pursuant to CERCLA and other Environmental Laws for hazardous substance contamination during its tenure regardless of the sale of property. Regardless, there are several steps for the Seller to consider.

Minimizing Liability Risks

First, the Seller naturally wants to avoid making any representations and warranties by selling on an "as is" basis; that is, without legal recourse for any defects. If this is not feasible, then the Seller will want to minimize the scope of any representations. Techniques for this include giving representations only as "to the knowledge of Seller" so as not to warrant or guarantee any particular condition, especially for matters which were beyond the control of the Seller, such as uses of the property by prior owners. Another qualification is contracting only as to "material" violations or other conditions to avoid spending time and money to investigate and discuss extremely minor or technical concerns of little consequence.

Second, to the extent the Seller retains liability for existing conditions, the Seller will want to retain some leverage. The Seller may want the Buyer to covenant to comply with Environmental Laws and promptly take any necessary response action so as to prevent any problem from worsening. Depending on the type of concern, the Seller may want the Buyer to covenant to refrain from engaging in any particular activities likely to aggravate any problems which exist at closing. The Seller also will want to require the right to notice of and records concerning any subsequent environmental issue. No matter how much control is given the Buyer over coordinating any response action, the Seller may want to retain the right to enter the Property and take corrective action in the event the Buyer fails to take appropriate measures to manage any problem.

Third, for any indemnity given the Buyer as to existing conditions, the Seller may want an indemnity as to post-transaction events. In addition, the Seller will want conditions on any indemnity. The longer ago the transaction took place, the less likely any latent problem will arise and the more difficult it will be to discern who was responsible. Consequently, acquisition indemnities often contain expiration dates and phase out schedules, so the Seller will pay a declining percentage of any liability over time. Other tools to manage indemnity exposure include a deductible and cumulative limit.

The Lessor

Perhaps, the most complicated situation is that of the Lessor. Like the Lender, the Lessor will have an interest in the other party's financial affairs, in this case, the Lessee's ability to pay the rental. Like the Seller, the Lessor will transfer its property to another party. Unlike the Seller, the Lessor not only will remain the owner, with all the associated responsibilities to third parties, but may get the property back at the end of the lease term. If not, then the Lessor will be interested in marketing the property to yet another party.

Given this overall position, the Lessor will want to learn about the Lessee's current and intended use of Hazardous Materials, compliance with Environmental Laws and environmental liabilities through representations and warranties like those in the attached sample in order to gauge risks to the property as well as the financial wherewithal of the Lessee. After ascertaining the Lessee's operations, the Lessor will want to limit the use

and disposal of Hazardous Materials through the use of covenants. For any legal violations or contaminations, the Lessor will want the Lessee to take response action and provide all related information, but with the right for Lessor to take over any response which the Lessee fails to implement properly. Anticipating the end of the term, the Lessor will want the right for prospective tenants or buyers to conduct an environmental review as well as for an assessment near the termination date to identify any needed response actions the Lessee should complete before returning the property.

The Lessee

The paramount objective of the Lessee is to avoid entanglements in environmental problems of somebody else's making. If the property turns out to be contaminated, then the Lessee may face CERCLA liability as an "operator" of the property, even if the Lessee did not cause the contamination. Like the Buyer, the Lessee will first want detailed representation and warranties, along with an environmental assessment, to document the baseline conditions when the Lessee received the property. Then the Lessee will want the right to terminate the Lease if latent contamination is discovered. As the end of the term approaches, the Lessee has an interest in documenting the return of the property in acceptable condition. Thus, the Lessee in other words will want to bracket the tenancy period to demonstrate that any problems were created before or after the tenancy. A risk to bear in mind during negotiations is that the bracketing approach can also identify any problems which arose during the tenancy.

The Lender

The most unknowns and "uncontrollables" usually are faced by the Lender. In the business of financing other ventures and properties managed by numerous different parties, the Lender ordinarily is not in position to known the environmental nuances of the Borrower's business or properties. So, like the Lessor, the Lender may be concerned about environmental liabilities and problems which can affect the creditworthiness of the other party. Like the Buyer and Lessee, the Lender may be interested in the environmental condition of specific property, particularly when the property is to secure the repayment obligation. Again, like the Lessor, the Lender may be vulnerable to environmental liability from supervising actions taken by a third party because the Lender who participates in management of the Borrower in the course of administering a loan sometimes can be deemed an owner or operator of the Borrower's contaminated properties pursuant to CERCLA.

The Lender, therefore, will want representations and warranties designed to disclose at least any materially adverse conditions as to the Borrower as a whole and to be relatively unqualified as to the conditions at any collateral. To minimize diminution in value and CERCLA exposure for any collateral, the Lender usually will want the Borrower to covenant to take any response action which may be necessary, even though this may reduce the Borrower's positive cash flow in the mean time. The appended sample response action covenant contemplates review by the Lender and use of an escrow

financial assurance mechanism. In some instances, the Lender may simply want to rely upon the Borrower's environmental consultant to take appropriate action rather than become entangled in remediation management. To avoid such situations, the Lender may want to restrict the Borrower's business and collateral use to avoid environmentally sensitive activities. Given the Lender's probably unfamiliarity with the nature of the Borrower's business and condition of any collateral, the Lender will want to obtain the right to environmental information as well as inspection by acceptable environmental consultants. In any case, the Lender usually can expect to receive the strongest indemnity of any type of transaction party.

The Borrower

The position of the Borrower seeking a standard loan is deceptively simple. The act of borrowing money seems unlikely to create any environmental liability. Thus, the objective of the Borrower would appear to be focused upon avoiding unduly burdensome covenants proposed by the Lender. The principal task of the Borrower often is determining how much reporting information the Lender really wants provided and narrowing any corresponding notice provisions. The Borrower will want to limit any response action duty to that of achieving legal compliance or eliminating health threats, and nothing more, rather than agreeing to dispose of all contaminants regardless of whether a legal violation has occurred.

But before negotiating covenants, the Borrower will want to consider an appropriate level of due diligence and disclosure to avoid indirectly aggravating environmental liabilities by entering into a loan. To make stringent representations and warranties, the Borrower may have to conduct investigations not necessarily required by law and which may involve matters subject to litigation or governmental enforcement actions. This could lead to adverse, discoverable information or trigger previously inapplicable reporting or remediation duties. The Borrower's primary objective may turn out to be limiting the scope of environmental representations and warranties.

Conclusion

There are a few laws governing the process and outcome of transaction negotiations. Instead, the parties must look to the inherent environmental risks of their respective positions to identify their respective interests. They are all likely to encounter universal concerns about defining applicable Environmental Laws and Hazardous Materials. Otherwise, the Buyer, Seller, Lessor, Lessee, Lender and Borrower will have diverging contractual objectives, which call for differing approaches to contracts.

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