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Environmental Issues In Commercial Transactions: *Tips, Traps And An Update On Moving The Deal Forward*

Twenty years ago environmental issues often proved to be a serious impediment to various commercial transactions. This was often due to a perception that these issues posed extraordinary or unquantifiable risks. Equally problematic was the belief that quantifying such concerns were always costly. As a result, transactions often failed or the value of the property or facility was significantly reduced.

By way of example, the simple presence of friable asbestos in a structure was frequently deemed a material issue. Similarly, any level of soil or subsurface contamination was considered a major impediment to a property sale or lease. In both instances, the liabilities arising from the issue were considered difficult to quantify or perceived to be significant.

Equally important, environmental issues potentially involved a wide variety of properties or facilities. The affected properties might include industrial, commercial, agricultural, office, and, in some

instances, residential properties. The transactional players involved in a transaction included:

- Purchasers;
- Sellers;
- Developers;
- Lessors;
- Lessees;
- Lenders (including the secondary market);
- Appraisers;
- Contractors;
- Architects;
- Material suppliers;
- Subcontractors;
- Property managers;
- Brokers/agents; and
- Attorneys.

Further, the business/facilities affected might vary from a third generation family oil jobbership having difficulty acquiring financing for some of its retail or wholesale facilities (with tanks) to a developer unable to determine the likelihood of obtaining a Clean Water Act Section 404 wetland permit from the United States Corps of Engineers to build multi-family units on a property with jurisdictional wetlands.

The purpose of this e-brief is to discuss the somewhat changed role of environmental issues in transactions today. It is arguable that many environmental issues that were formerly deemed potential “dealbreakers” or unquantifiable are now routinely addressed in the same manner as other transactional tasks such as title searches, appraisals, etc. This is due, in part, to developments such as:

- Familiarity;
- Improved ability to quantify environmental issues;
- Experience;
- Revised or clarified liability principles;
- Improved assessment techniques;
- Easier access to government records;
- Standardized assessments; and
- Efforts by federal and state agencies to reduce, to the extent possible, the environmental regulatory/liability impediments to financing and/or acquiring/leasing existing facilities.

In other words, a number of tools and/or information unavailable 20 years ago have placed transactional players in a position to better identify, quantify, manage and resolve environmental issues.

Nevertheless, depending upon the type of transaction and/or the issue, the early identification and creative work is still sometimes needed to close a transaction. The objective is to utilize cost effective tools to assess and/or quantify potential concerns. However, there is a tendency to deal with some issues in a “cookie cutter” manner which may overlook subtle problems that pose material risks. It is also important to be prepared to anticipate and address new issues that inevitably arise in the transactional context.

This e-brief uses hypothetical scenarios to illustrate the roles environmental issues play in various transactions. The tools and/or information used to address various environmental issues are described. In addition, this presentation will attempt to point out traps or mistakes that can occur in some situations.

Finally, there are three key questions that may be relevant in determining the materiality of a particular transactional environmental issue:

- Costs associated with permits/authorizations;
- Amount and/or likelihood of corrective action/third party property damage/bodily injury claims associated with a property or facility;
- The cost (legal/technical, etc.) to determine/quantify/clarify the first two issues.

The following “hypothetical” scenarios illustrate some of the potential issues.

1.

The Attorney’s Role in a Transactional Assessment

Acme, Inc. (“Acme”) is considering the acquisition of a commercial facility. Acme will use an environmental assessment to identify and/or quantify the issues associated with the property. Acme asks its attorney to secure a “standard environmental assessment” of the facility to be acquired. The complex consists of a number of office and multi-family facilities including an unimproved area that is slated for further development. Some of the structures will be demolished or renovated.

2.

Water/Future Needs

Acme Bank is considering financing a significant portion of the cost of constructing a large manufacturing facility that will consume significant amounts of water in its production process. As part of its due diligence, Bank queries borrower on:

- (a) The amount of water it will need on an annual basis;
- (b) The source(s) of water it will utilize;
- (c) The ability of these source(s) to produce the required amount of water during drought/dry seasonal periods;
- (d) Its legal right to use these source(s) of water;
- (e) The likelihood that other riparian users will affect borrower's ability to use this water now or in the future; and
- (f) Other impediments to riparian use.

Bank asks borrower's counsel to provide an opinion addressing the certainty that this water can be acquired on an annual basis in the needed amounts? Bank also asks whether there may be other mechanisms (statutory/regulatory) or otherwise (purchase of water from off-site) which might provide borrower greater certainty that it can access the needed water (even non-riparian)? Further, the potential impact of an "ESA" listing is referenced.

3.

Purchaser Exemption/Third Party Claims

Acme Bank has been asked to finance the purchase of twelve bottling facilities being sold as a package. Preliminary due diligence indicates that four of the twelve facilities may have sub-surface or groundwater contamination. Three involve releases from petroleum USTs while the fourth appears to be related to solvents spilled over time from a vehicle maintenance operation. One of the UST releases and the vehicle maintenance contamination may have moved off site. Borrower's counsel notes that bank is exempt from statutory liability for any of the releases because of the respective statutory secured creditor exemptions. Regardless, bank expresses concern about both liability and valuation issues and asks whether there are other products or actions which may help address either? Acme Bank's environmental consultants' further note that five of the properties have wastewater pond impoundments. Three of the ponds are "inactive" and two are in operation. Borrower states that the ponds have simply been used for treating "bottle washing water." The bank's environmental consultants are asking for sub-surface sampling adjacent to these ponds? The state agency is not aware at this point of the sub-surface contamination related to solvent storage (unlike the petroleum releases which were reported in accordance with the UST agency notification requirements). An environmental consultant for the buyer states "that the agency must be notified of this solvent release." A potential purchaser who walked away from the potential acquisition based on concern about governmental liability complains to his counsel that federal and Arkansas statutory exemptions would have eliminated responsibility upon acquisition?

4.

Permitting/Compliance Audit

Acme is negotiating to purchase several manufacturing facilities from Puffs, Inc. ("Puffs"). These facilities hold various air and wastewater permits. Acme wants to conduct a comprehensive audit to determine the compliance status of the facilities. Puffs is concerned about the potential results of such an audit as it has limited funds to address identified deficiencies. Further, Puffs demands a comprehensive confidentiality agreement for both Acme and its environmental consultant conducting the audit. Acme replies that to better understand what capital will be needed to invest to upgrade the relevant pollution control equipment after the acquisition, it may need to discuss various permitting issues with state agency personnel. Both parties are concerned about the ability to transfer the existing permits as the transaction is on a "fast track."

5.

Tank/Corrective Action Issues

Acme is selling several retail convenience stores utilizing underground storage tanks (“USTs”). Sponge Bob, Inc. (“Sponge Bob”) is negotiating to acquire these retail outlets. Sponge Bob is somewhat risk intolerant and does not want to acquire properties with significant environmental liabilities. Sponge Bob is pleasantly surprised that he has obtained an arrangement with Acme in which it agrees to undertake a pre-closing investigation of the facilities and remediate (post-closing) any petroleum contamination discovered “in accordance with applicable federal/state environmental requirements.”

6.

Acquisition/Offsite – Issues

Acme and its attorneys are negotiating to acquire a manufacturing company (Squidward, Inc.) with four plants. One of the issues they are assessing is whether the company will be acquired through the purchase of its assets or stock. In weighing the pros and cons of each approach, the tax, corporate and other aspects of the choices are examined. However, it is also noted that three of the Squidward, Inc. facilities have, for years, sold processed by-products for beneficial reuse offsite. In addition, preliminary due diligence also indicates that Squidward, Inc. would often supply fueling equipment to some of its customers. Squidward Inc.’s records regarding past loans of equipment are incomplete. In the event the deal is an asset sale, Squidward, Inc. is planning on using the existing corporate entity to develop and market new products.

7.

Unknown Conditions/Trust Fund Transfer

Acme is proposing to sell several facilities in a very short timeframe. The key potential environmental issue is the fact that for many years, both above ground and underground petroleum storage tanks have been utilized at each of these facilities. The potential buyer, Mr. Krabs (“Krabs”), has a minimum tolerance for environmental risks but does not want to fund sampling of any kind. Acme suggests that both Arkansas and Oklahoma (where the facilities are located) have storage tank trust funds that would cover post closing investigation/remediation of petroleum contamination. As a result, Acme and Krabs discuss both the appropriate due diligence to verify trust fund eligibility and the contractual provisions for various scenarios. Some of the oils that have been stored are synthetic. Acme notes that it is currently undertaking investigation/remediation of a UST release being funded by the Arkansas Petroleum Storage Tank Trust Fund. Acme informs buyer that it can simply transfer this trust fund eligibility (to address this known release) to Krabs. Krabs asks whether the state would agree to this transfer?

8.

Loan Portfolio/Secured Creditor Exemption

Acme Bank is undertaking due diligence as part of a potential acquisition of another bank. In reviewing the target’s loan portfolio, it notes that the bank had, at one point, foreclosed upon a ten acre property on which a former borrower (and others) had placed construction debris from its home building business for “fill” purposes. The target bank tells Acme that this property should not be a concern because of the federal and state “secured creditor” exemptions. Acme ponders this question and also considers what additional due diligence/investigation it might undertake to better quantify the risks associated with this issue? Target bank expresses concerns about such investigation as the property is now owned by another person to whom the bank had sold the property(also providing financing).

9.

Funding/Due Diligence

Acme is negotiating the sale of several large multi-family apartment complexes to Plankton, Inc. (“Plankton”). Simultaneously, Plankton is discussing loan terms and underwriting criteria for funding the acquisition. Both Plankton and its bank have had some recent negative experiences with facilities that suffered third party property damage/ bodily injury claims due to water intrusion causing “excessive” fungi growth. As a result, Plankton and its bank initially propose to Acme contract terms requiring the “absence of fungi,” intrusive sampling, etc. Acme expresses concern about the breadth of these terms and the cost of such due diligence (which would be split between the parties). Acme considers whether alternative warranties might be workable along with a more tailored initial due diligence?

10.

Leasing/Historical Conditions

Acme is negotiating a long-term lease of a large parcel of property from a county-owned industrial park. The county initially proposes environmental lease provisions that contain broad prohibitions or restrictions on the use and/or storage of petroleum, hazardous substance, etc. The lease terms posed problems for Acme’s projected operations (scrap recycling, processing, etc.). Further, Acme’s initial due diligence on the leasehold property indicates that several prior owners/operators of the parcel could have potentially caused soil and/or groundwater contamination. The county refuses to provide Acme any type of indemnity. Acme considers whether, and at what cost, an environmental baseline might be established distinguishing conditions associated with its prospective use from those associated with prior uses? Acme also notes that if it was purchasing the property (as opposed to leasing), it might qualify for federal and state innocent landowner and/or bona fide purchaser exemptions. Acme wonders whether a similar exemption might be available for its lease of the parcel? However, it also worries that future corrective action at the facility might affect/ restrict its operation.

11.

Environmental Assessment/Role of the Attorney

Acme is considering the acquisition of multiple facilities of a service business. Acme’s president asks its outside counsel to “handle the environmental issues.” Acme’s plans include renovation and/or demolition of several of the seller’s structures. In addition, several oil stained areas associated with fuel spillage have been noted at two of the facilities. Acme’s counsel considers the scope of the potential environmental assessment and whether her law firm will retain the environmental consultant. Counsel questions her role in determining the due diligence required to investigate and assess the environmental risks associated with the target facilities. Multiple tanks are involved that are both above ground and underground. Counsel recognizes she will be asked to provide Acme contractual options for addressing both the known and unknown environmental risks associated with the target facilities (i.e., “as is” versus broad warranty/complete indemnity). A critical issue will be a post-closing dollar cap on environmental issues seller is proposing.

12.

Timing/Remediation

Acme is proposing to sell two convenience stores to a discount retailer chain that will demolish the site structures for redevelopment. One of the site’s USTs has suffered a release for which Acme’s environmental consultants are performing an initial investigation to delineate both the extent of contamination and remediation alternatives. The retailer purchaser needs to consummate the transaction quickly for tax driven reasons. Despite the fact that Acme is a well funded seller and performing the investigation using state trust funds the retailer purchaser is concerned about both short term investigation/remediation timing issues and its future ability to place structures on the property.