# <u>THE REAL ESTATE ATTORNEY'S ROLE IN A BUSINESS ACQUISITION</u>

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In the current business environment, we are seeing a great deal of corporate acquisition activity and all indications are that this will continue for some time. Particularly significant is the level of activity of foreign corporations acquiring businesses that supply parts to the auto industry.

Whether these transactions take the form of an asset purchase, merger or stock acquisition, the real estate and environmental issues remain basically the same.

The role of the real estate/environmental lawyer in one of these transactions tends to be very different from that in a normal real estate transaction. All deals are ultimately driven by price and value – if the client is getting a valuable asset at a favorable price, it will inevitably be prepared to accept a greater business risk.

In the purchase of raw land or a non-manufacturing asset, such as an apartment complex, office building, or hotel, the real estate lawyer has much greater control of the deal and real estate and environmental considerations are of prime importance. In the acquisition of a manufacturing operation, corporate lawyers and, frequently, investment bankers, tend to drive the deal and real estate and environmental issues may be

addressed very late in the game. This can lead to serious problems. A couple of real world examples may serve to illustrate this.

Case 1 – You Mean There Could be Environmental Problems?

An out-of-state firm engaged us as local real estate and environmental counsel for the acquisition of a business located in the Upper Peninsula. It was vital that the transaction be closed by December 31, so that the seller could book it by the end of the calendar year, or the price would substantially increase. Initially, we were engaged merely to comment on points of Michigan law. On December 23, however, we received a panic telephone call. The purchasing company and its lead counsel each assumed that the other had acquired an adequate environmental report, but neither had. We were asked if we could step in and fill the breach in a week's time.

Fortunately, we were able to persuade a reliable consultant to give up part of his Christmas vacation and fly to the Upper Peninsula to at least do a walk-through of the facility. In reviewing records, he found that there had been a spill of a substance regulated under the Federal Resource Conservation and Recovery Act (RCRA), that the spill had been cleaned up, and that there appeared to be adequate documentation of the cleanup. Since he was on-site however, he asked to speak to whoever had been in charge of the cleanup crew. That was a long time employee from the maintenance department, who was promptly produced to be interviewed.

The first thing the maintenance employee said was, "I don't see why everybody gets so concerned about that spill cleanup. I should think people would be much more interested in the pit."

It turned out that the pit was a large hole in the ground that the company had used, in years past, to dispose of whatever it wanted to get rid of – waste paper, empty drums that had held chemicals, waste cutting oils, paint waste, solvents sludge, etc. In short, the pit was an unlined hole in the ground that held an alphabet soup of hazardous waste. A plant addition had been built over the top of the pit. The plant manager, the plant's chief engineer, and the parent corporation's environmental manager had all joined the company after the addition was built and weren't even aware of the existence of the pit.

We received this news from the consultant on the evening of December 29. We passed the news on to lead counsel at the pre-closing on December 30. Everybody agreed that the closing had to go forward and it did, but the seller had to give the most extensive environmental indemnity that you could possibly imagine.

Case 2 – You Mean We Need A Survey?

We were engaged as local real estate and environmental counsel by the New York office of a British firm representing the purchaser of a division of a Michigan manufacturing corporation. The seller operated two divisions, in separate factory buildings, on a single parcel of real estate, so a lot split was necessary. In addition, access was across a private road serving both factories. Naturally, both seller and purchaser shared a desire to close this transaction rapidly and we were engaged at the last minute.

Purchaser's counsel had never heard of the Michigan Land Division Act, of course, and, inexplicably, a major Michigan firm that was representing the seller had not considered land division concerns. It turned out that the municipality had a land division

ordinance that required, among other things, a survey. The seller had not bothered to get a survey. The parties had settled, again, on a December 31 closing date. By the time an expedited survey was obtained and the application for approval of the lot split was filed with the municipality, it was the week before Christmas and everybody was on vacation.

Ultimately, we closed, but not until well into January. This posed a serious problem for both the seller, which needed the money desperately, and the purchaser, which had made some imprudent commitments to its customers about when production from the facility would be available.

The moral of these stories is that real estate and environmental issues do arise to complicate corporate acquisition and sale transactions and these issues can sometimes be major ones that take time and thought to resolve. Many dealmakers do not realize this, however – or else they forget it in the heat of combat. It is therefore important for us to constantly remind our colleagues in the corporate practice to include us from the beginning in the team working on a deal. One of the quickest ways to derail a corporate deal is to negotiate the basic terms, including the acquisition price, and then discover that there are major real estate and/or environmental issues requiring re-negotiation of the price or other major terms.

At the same time, we must address the real estate and environmental issues within the framework of the transaction. For this reason, the real estate/environmental lawyer's first step, upon being brought into the deal, should be to read the entire draft Acquisition Agreement to fully understand the deal and the framework within which we must work. We need to understand the level of business risk which the seller and

purchaser are each willing to incur, the time frames (both pre-closing and post-closing) for resolving major issues, and the extent to which seller and purchaser are prepared to cooperate to resolve those issues. It is therefore appropriate, before discussing specific real estate or environmental issues, to consider the structure of the typical acquisition.

## The "Typical" Business Acquisition

Management for the parties, with or without guidance from the investment bankers, often reach a preliminary "understanding" on the following items before the attorneys are involved:

1) To transfer all assets necessary or currently used for the operation of one or more business enterprises, as well as a transfer of related liabilities. Certain assets (such as cash) and certain liabilities (such as debt to related parties) may be carved out of the deal.

2) The purchase price is determined – perhaps a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization) from past and/or future years.

3) The structure of the actual transaction as an asset acquisition or a stock acquisition – or as a combination of both when, for example, the business location(s) are owned by a separate, albeit related, entity.

4) Special concerns such as employment contracts, covenants not to compete, assignment of licenses, etc. may also be discussed by management.

After the above "understanding" is reached either orally, or in some form of "letter of intent", attorneys for the Purchaser undertake the serious work of assuring that their client actually receives what he thinks he is going to buy. With this in mind, the attorney for the Purchaser (typically) begins the process of fashioning an Acquisition Agreement document which contains within its architecture, the following four interactive and complementary sections designed to protect the Purchaser's "understanding" of the deal:

A. Representations

B. Warranties

C. Conditions

D. Indemnities

Discussing the resolution or management of the various real estate issues in the context of these four sections may be helpful. Thus, we have provided a short discussion of each followed by cross-references to the corresponding section or sections from the first sample document (Sample Document A):

A. **Representations and Warranties**. These are statements of a specific condition at a specific time much like a "snapshot". Representations refer to present or past time and warranties typically refer to how things will be at the moment of Closing.

See page/section 3-9/3 for typical representations and warranties of Sellers.

B. **Covenants**. These are affirmative or negative undertakings relevant to pre-closing behavior. They relate to a period of time. Much like a movie rather than a snapshot. They indicate what a person will do or refrain from doing. Covenants are only relevant

when the closing follows the execution of the Acquisition Agreement and is not simultaneous with the execution. See 10/5 for the subject matter of typical covenants.

C. **Conditions.** These provide “walk” rights and are conditions precedent to the obligation to close. See 10-11/7 for typical conditions and see 11-12/9 for related termination or “walk” rights.

D. **Indemnities.** These obligations apply after closing where there has been a breach of the Agreement or where a representation or a warranty has been violated. The right of indemnification may apply even after a Buyer has exercised “walk” rights under certain circumstances. Numerous refinements, variations and custom-made provisions are frequently employed to make the indemnification obligation fit a specific deal. See 12-16/10.

The representations and warranties, conditions and indemnity provisions are typically expanded, limited and otherwise tailored to the specific transaction through a number of devices and provisions provided for or found within the typical Acquisition Agreement. Here are some examples of such devices and provisions with cross-references to relevant portions of Sample Document A:

1. **Disclosure Letter.** This is a document that will accompany the typical Acquisition Agreement. The representations and warranties of the Seller are made and given subject to the disclosures in this letter. In some acquisition agreements, schedules are used rather than a disclosure letter. The effect is the same. See the language of any of the representations made at 7-27/3 of Sample Document A.

2. **Supplement to Disclosure Letter.** This is a formal disclosure of inaccuracies in the Seller’s prior representations and warranties presented by the Seller to the Buyer after the Acquisition Agreement has been signed but before Closing. The Supplement to Disclosure Letter may limit the scope of the Buyer’s remedies arising from the matters disclosed to “walk” rights without right of indemnification. See 13/10.2(b) of Sample Document A.

3. **“Walk” Rights.** This remedy, with and without the right to indemnification, typically applies when a material Condition has not been satisfied. See 11/7 and 12/9.1(a-c).

4. **Indemnity Rights not Affected by Buyer's Knowledge.** See 13/10.1. The provision states that Buyer's knowledge of inaccuracies in the Seller's representations and warranties is not a defense to Buyer's claim for indemnity. This is a matter on which Buyers and Sellers may have legitimate disagreement.

5. **Indemnity Limits.** These may include a dollar ceiling or "cap" (16/10.6); time limitations within which an indemnity claim must be brought (15/10.5); and thresholds consisting of a minimum amount that must be exceeded before indemnification is required after which Buyer may then collect the excess (18/10.10) or in some deals, begin collection with the very first dollar.

6. **Baskets.** A group of items measured in the aggregate against indemnity Caps or Thresholds. Alternatively, limits may be applied on a claim by claim basis. See 10.8 for an example of a "threshold" applied to a basket allowing the Buyer to collect upon the excess.

7. **Covenant to Supplement.** An agreement to promptly update the Disclosure Letter prior to Closing. It may or may not form the basis for indemnification where Buyer chooses to close. See 10/5.5 and 14/10.2(b) of Sample Document A.

8. **Materiality Requirements.** These are relevant for "walk" rights (see 11/7.1(a) of Sample Document A) but not for representations and warranties. With representations and warranties "caps" and "thresholds" are typically utilized instead.

9. **Holdbacks and Setoffs.** These are used as collection or security devices to help assure collectibility as to indemnification claims. Deferral of payment with right of setoff (see 15/10, 7 of Sample Document A) and use of escrows are typical.

10. **Definitions.** Often bunched together at the start of an acquisition agreement or at the end. These key provisions are often not reviewed (or even made available by some drafters) until the entire document has been negotiated! See a few selected definitions at pages 20 through 23 of Sample Document A.

Now let's discuss some specific real estate and environmental issues.

## Real Estate Issues

If the purchaser intends to operate the business at the same location(s) it is going to need to acquire rights to real estate and factory building(s), whether the seller owns or leases those. This means that the purchaser is going to be faced with the usual need to examine title to owned real estate or examine title and address the lease assignment for leased property. This is normally a fairly straight forward procedure with which we are all familiar, so I will only comment on one recent surprising experience.

A client was purchasing vacant land in Oklahoma from a California company which insisted upon using a title agency in Dallas to issue the title commitment and to serve as escrow agent to close the deal. Naturally, despite the difficulties of people in three different time zones being involved, the client really did need to close the deal quickly and start construction of its plant. We were surprised to learn that there would be a substantial delay in the issuance of the title commitment by the Texas title agency because the property was in Oklahoma. We were told that Oklahoma is by statute an abstract state; consequently, the Texas title agency had to have a sister agency in Oklahoma continue an abstract to date, examine it, and render a title opinion as the basis for a title insurance commitment to be issued in Texas.

I don't know if there are any other states besides Oklahoma that have such a requirement but, if so, be prepared for a delay in the issuance of a title commitment; otherwise, be prepared to have an abstract brought down to date, examine it, and render a title opinion.

There are some particular real estate issues which seem to have a way of coming up and sometimes causing problems when one is acquiring a manufacturing

facility. These problems can be exacerbated when a deal is being driven by the business lawyers and the client's financial advisors, so that the real estate lawyers are not being fully informed of the client's development plans for the property.

The first of these issues is easements, be they for petroleum pipelines, utilities, or railroad side tracks, which may have been given many years ago and where it is not clear whether the easement has long since been abandoned or is still in use. Hopefully, a good survey will shed some light on the question. (Hopefully, the dealmakers will have negotiated for a current ALTA survey in order to get a title commitment with standard exceptions deleted, but don't bank on it.)

We have found cases, however, where the surveyor cannot locate the old easement, especially if it was given as an easement in gross, and where it may not be clear whether the easement holder is still in existence or may have been merged into some other company. We have also found that railroad sidetrack agreements have a way of getting lost. Neither the property owner nor the railroad seem to be able to find them, but the tracks are there, so the purchaser is on notice that there is undoubtedly a sidetrack agreement. Further, experience with sidetrack agreements suggests that they will provide extensive rights to the railroad and possibly create a serious burden upon the land.

What the client has not told you about future plans for the property can become a serious problem. For example, does the purchaser plan to substantially increase production at this location and, therefore, plan a major expansion of the buildings? If so, the real estate lawyer should know this because it may raise issues of zoning, local set-back requirements, a need for additional curb cuts for driveways, and conflicts

between future expansion plans and existing easements. These issues should be identified and resolved in the pre-purchase due diligence investigation. Also, the issue of signage may be a thorny one. If the purchaser plans to use larger or higher signs to identify itself at the property, are there local restrictions to prevent this? If the property is adjacent to or near a state highway, are there state restrictions? Again, the real estate lawyer needs to know all this during the due diligence investigation.

It is surprising how many times we have seen serious access issues at older manufacturing facilities. Typically, the issue arises when the title commitment fails to establish that a vital access road is either a dedicated public road or that there is an easement for its use. Plant personnel are surprised, but not too concerned, because they have been running trucks in and out over that road for years, so there can't be a problem. The purchaser may take a different view, especially if it must satisfy a lender concerning adequacy of access to the property.

We find the entire subject of "adequacy" of access and parking to be an interesting one. Draft Acquisition Agreements seem to routinely include a representation by the seller that there is "adequate" access to the property and parking on the property. The problem is the definition of "adequate." Suppose the purchaser is planning to expand operations and will need to accommodate parking for more employees and access for more trucks? Is the access and parking adequate for that purpose? Of course, if a dispute later arises, the seller will take the position that the access and parking were adequate for the operation as it was conducted at the time of the sale. The purchaser may argue that the seller was aware of its intention to expand the plant and, therefore, the representation should be construed to cover at least a

reasonable increase in parking and access requirements. The only solution to this problem is to spell out in the Acquisition Agreement exactly what the representation means. If it means that access and parking are adequate for the operation as it currently exists, say so and avoid a dispute and, possibly, litigation later.

We have already briefly mentioned the problem of a lot split, where the purchaser is buying factory buildings and only part of the real estate which the seller owns. While that issue may not arise frequently, it can be a very difficult and time consuming one when it does.

The people who are driving the deal may consider real estate issues to be routine and minor – one has a commitment for a title insurance policy issued a few days before closing and that's that. Some of the issues enumerated above, however, may take more than a few days to resolve. It is therefore desirable to persuade the drafters of the agreement to build enough time into it to allow for the adequate resolution of real estate issues. If they do not, one is then faced with some serious questions about what to do. Do you go ahead and close, with the understanding that the real estate issues will be resolved after closing? What if they are not? Is money escrowed to deal with those issues? If so, how much? If the problems are to be resolved after closing, who will take responsibility for corrective action? One of the provisions we have seen in a number of draft Acquisition Agreements is that the purchaser may take any corrective action it considers necessary <u>at the expense of the seller</u>. I have never seen that in the final agreement, but I have seen a number of people try to slip it through in a draft.

## **Environmental Issues**

In the normal real estate deal, we are all accustomed to doing a property assessment (I hope) and, if the property is located in Michigan, filing a Baseline Environmental Assessment (BEA) report with the Michigan Department of Environmental Quality, if appropriate. (Some of us even file the BEA report with the MDEQ when the property does not qualify under the Statute as a "facility," because we like to get the letter from MDEQ rejecting the report on the basis that the property is not a "facility" so that we can show it to our lender.) When purchasing a manufacturing business, however, there are far more environmental issues to be considered. If the purchaser plans to operate the business at the same location, of course, it still needs to do an adequate property assessment and to seek whatever protection it can get under the law of the forum state to assure it that there is no status liability attached to the property. Remember that Michigan is the only state that has the protective BEA procedure, so it will be important to check state law in other states to find out what protection, if any, is available. In many states, there is no such protection available for a new owner or occupant of property, so the pre-purchase or pre-occupancy investigation is the only protection that there is against status liability.

Also note that we have addressed both pre-purchase and pre-occupancy protection. Some clients still seem to think that if they are leasing the factory building and property they are free of liability for any site contamination. This is not true. Federal law and the laws of all the various states impose status liability, at least in some circumstances, upon the operator, as well as the owner, of the site.

There are three sources of environmental risk which may need to be evaluated in a corporate acquisition transaction, especially one that involves a manufacturing operation. A valuation of each of these risks involve a different scope of environmental investigation, although they are frequently combined and done simultaneously. The three types of investigations are: a property assessment; an environmental compliance audit; and an environmental risk audit. We will briefly describe each type of investigation.

The Property Assessment. This is the type of investigation with which most real estate lawyers are familiar. It is done most cost-effectively in phases. What has come to be referred to as "Phase I Investigation" involves accessing all sources of information that can be checked without invasive testing methods. This includes checking numerous governmental data bases for information about the subject property and environmental conditions on adjoining property; study of historical aerial photographs to identify prior suspicious uses; study of any available previous environmental investigation reports; an on-site observation of both the subject property and adjoining properties to see if there are obvious signs of possible contamination, such as stained soils, stressed vegetation, discolored or oily run-off or pools of liquid; and interviews with site operating personnel.

If the Phase I Investigation indicates that there may be environmental contamination issues – and with a manufacturing facility, there probably will be such indications – it is necessary to proceed to what has come to be known as a "Phase II Investigation." Actually, a Phase II Investigation may involve several phases of testing, including soil borings, installation and sampling of groundwater monitoring wells, wipe

samples of suspect surfaces both inside and outside of buildings, sampling water and sludge from drains, and sampling any other suspect areas.

If adequate time has been built into the due diligence investigation schedule, such an investigation is best done in phases because it can be more accurately focused and completed at a much lower expense.

It is desirable to have at least 90 days available for this investigation, preferably more. It is possible to complete the investigation in less time, say, 60 days or maybe even as little as 45 days, but the cost may increase drastically. Instead of focusing on only those parts of the property which initially show contamination and then doing step-out borings and/or monitoring wells to determine the extent of the contamination, an expedited investigative program may require the installation of far more borings and monitoring wells at once. When one considers that the cost of a drill rig and a hydrogeologist to supervise it may run from $2,000.00 to $3,500.00 per day, installation of excessive numbers of soil borings and monitoring wells becomes extremely expensive. In addition, the most expensive part of a site assessment investigation is normally the laboratory work, so running the extra samples through the laboratory, analyzing them all for a larger number of substances before a specific target analyte list can be compiled, and, possibly, paying a 200% premium for accelerated turn-around from the laboratory can drive the laboratory costs up astronomically. If the client insists upon having the environmental investigation expedited, a quality, cooperative environmental consultant can do it up to a point. The client should understand, however, that it is signing a blank check when it demands this kind of speed.

We do not offer any observations about the cost of a "typical" Phase II assessment, because there is no such thing. The cost will depend upon the size of the property, geology of the site, nature of operations at the site over the years, and the nature and extent of contamination. Environmental consultants are accustomed to being engaged on the basis of proposals, frequently of competitive proposals, so a good consultant will be happy to provide a proposal for each phase of the investigation. Just remember, getting, reviewing, and approving a phase-by-phase proposal adds more time to the investigative process.

It is also important to remember that the purchase of a manufacturing facility may require a more detailed environmental site assessment than does the normal investigation that we are accustomed to doing before purchase of real estate. Normally, we only want to know if the property is contaminated and, if so, in general terms the nature and extent of the contamination to make a decision whether to buy it. If we are willing to accept some cleanup cost in purchasing a manufacturing operation, we may need to have a much more detailed assessment of any site contamination so that we can accurately determine the size of the cleanup cost.

<u>The Environmental Compliance Audit</u>. The environmental compliance audit also focuses exclusively on the site, but it is not concerned with the condition of the property. Rather, this investigation focuses on the current site operations and whether they comply, in all respects, with applicable environmental regulations.

The investigator will be interested in studying ongoing operations, appropriate records, manufacturing safety data sheets (MSDSs), and, possibly, purchasing records to analyze manufacturing operations, materials used, by-products and waste product

which result from operations, and how they are managed. The investigation will consider how hazardous chemicals in inventory are stored, how waste is stored pending disposal, whether properly permitted shippers are employed to transport the waste to disposal sites, whether proper disposal sites are used, and whether this is all documented in required detail.

The auditor will also determine all the permits which may be required for the operation, such as air emissions permits, permits for operation of air monitoring and quality equipment, sewer discharge permits, groundwater discharge permits, stormwater discharge permits, etc. He will also be concerned about evidence of compliance with the conditions of all the permits. For example, if a sewer discharge permit requires monthly sampling at the sewer outfall to demonstrate that excessive amounts of contaminants are not being discharged in wastewater, are there records to establish that the monitoring is being done? Do those records indicate that the wastewater being discharged is within limits? If not, is there evidence to indicate that any excursion from limits is the result of a temporary upset or, if that is not the case, have steps been taken to correct the exceedances?

Have the necessary notifications been filed with all of the appropriate regulatory agencies? For example, if electrical equipment in a mechanical room contains PCBs, are the doors and any hallways leading to the mechanical room labeled with the appropriate PCB symbol? Has the local fire department been advised of the presence of the PCB on-site? Has facility management done the required inventory under the Emergency Preparedness and Community Right-to-Know Act (Title III of the Superfund Amendments and Reauthorization Act) and, if necessary, have the required chemical

inventory and notices been filed with the local emergency preparedness agency and fire department?

Finally, if the facility holds all the necessary permits – Federal, state and local – are all of those permits transferable to the purchaser or do some of them contain special conditions which prohibit their transfer?

The purpose of this investigation is to determine that the operation is in full compliance with all environmental regulatory requirements so that the purchaser will be able to buy a compliant, going business. Otherwise, of course, there is the risk that the day after closing, an environmental regulatory agency may visit the factory and issue a non-compliance notice which can result in a substantial penalty or, even, in certain circumstances, order the plant shut down.

If the operation is not in full compliance, of course, the purchaser will need to know exactly what will be required to bring it into compliance, how long it will take, and how much it will cost. The cost can be substantial if major capital outlays for new equipment are required. In addition, the lead time for delivery and installation of that equipment could leave the purchaser exposed to environmental regulatory enforcement initiatives for an extended period of time.

We want to conclude this discussion of the environmental compliance audit with an optimistic note. It has been our experience that if a factory has real compliance problems and the prospective purchaser sends its environmental consultant to mend fences with the regulatory agencies, the purchaser can almost invariably get itself a reasonable period of breathing space to bring the facility into compliance. Typically, a regulatory agency will agree to give the purchaser three to six months after it takes over

if it has major work to do. The purchaser had better make good use of that three to six months, though, lest it face an angry and vindictive regulatory agency at the end of that time.

The Environmental Risk Assessment. When we have done the Property Assessment and the Environmental Compliance Audit, there is still one source of extremely expensive environmental risk to be checked out -–the off-site environmental risk. The Environmental Risk Assessment addresses the question, “If I buy this business, am I purchasing a Superfund liability?” This investigation combines the site assessment with an attempt to determine the nature and scope of potential off-site liability; thus, it attempts to determine whether there may be major expenses incurred either for cleanup of the site or for cleanup of an off-site treatment or disposal area.

The whole subject of potential successor owner liability for off-site contamination, such as a Superfund cleanup of a landfill to which the company sent waste materials, is one that is not well understood by many business people. Indeed, a few years ago I was representing a prospective purchaser of a business and discovered that it had potentially large liability because of a landfill that had become a multi-party Superfund site. When I explained it to the investment banker who was trying to push the transaction to closing, he asked, “Well, should we do a Phase I assessment?” I trust it will be obvious from what we have already said, and from your own experience, that a Phase I assessment of the property was not going to tell us anything about the size of the liability at a Superfund site 20 miles away. Obviously, investment bankers who are driving the deal don’t always understand this.

The Environmental Risk Assessment is where we encounter the really large potential expenditures – the disaster costs, if you will. Cleanup costs may be difficult to project accurately, especially if the environmental investigation has been limited by time or cost.

It should be obvious that it is essential to have these investigations done by a top quality environmental consultant. There is no substitute for quality in this area. If the client engages a consultant on the basis of the lowest cost, it will usually end up costing him more in the long run. On the other hand, the fact that a consultant is expensive is no guarantee that it will do a quality job. Our advice, if you need a good consultant and are not experienced with one that satisfies you, is to get referrals from people whose judgment you trust. When you ask them for a referral, though, be sure to ask who has done good work for them within the past year, or two at the most. Consultants are only as good as the project staff that they assign to a given task and there is a certain amount of movement from job to job within the industry, so the fact that a firm did a good job five years ago may not mean much today.

Having gotten all this information about the environmental situation, we must now decide what to do about it.

## Managing The Risk

Having thoroughly analyzed the environmental issues, the question then becomes what can the real estate/environmental lawyer do to eliminate, reduce, or otherwise manage the risk. This is the point at which counsel has the greatest opportunity to demonstrate value added to the process. The first effort, of course,

should be to eliminate as much of the risk as possible. An effort should be made to avoid successor liability for off-site environmental problems, if possible, and to take advantage of any State programs which offer protection.

Successor Liability. In many jurisdictions, the rules for successor environmental liability may be different from the traditional rules for corporate successorship; therefore, the real estate/environmental lawyer needs to be certain that the corporate lawyers carefully consider how they need to structure the deal to attempt to avoid off-site liability resulting from disposal practices prior to the time that the assets were purchased.

In most Federal jurisdictions, the courts apply an expanded version of the continuity of business enterprise test to determine corporate successorship. The exact test varies between Federal circuits, so the Federal law must be analyzed for each location. It should also be noted that the law of successor liability in a given state may be different in Federal court that it is in State court. This has resulted from the fact that all of the U.S. Courts of Appeal, except one, which have considered the question have decided that Congress intended that the Federal Courts should develop what they have referred to as a "federal common law of CERCLA." This is necessary because Congress had did such a terrible job of drafting CERCLA – the Superfund Statute – that the Courts have had to develop a federal common law of CERCLA in order to interpret the statute. All of those Circuits which have considered the question, except one, have decided that some expanded form of the continuity of business enterprise test applies, but there is some variance in the expanded form of the test which they have adopted.

The one exception to this approach is the Sixth Circuit. That Circuit held, in Anspec Co. Inc. v. Johnson Controls, Inc., 922 F. 2d 1240 (6th Circ. 1991) that in

determining successor liability, Federal Courts in this Circuit should apply the law of the forum State.

Michigan was one of the first States to adopt an expanded version of the continuity of business enterprise test, in Turner v. Bituminous Casualty Co., 397 Mich. 406 (1976), but that was in a products liability case. In City Management Corp. v. U.S. Chemical Co. Inc., 43 F. 3rd 244 (6th Circ. 1994), the Court of Appeals predicted that the Michigan Supreme Court would restrict the ruling of Turner to products liability cases and would not extend it to matters of environmental successor liability.

For the moment, then, it appears that in Michigan one can avoid liability for prior off-site contamination by structuring the transaction so as not to come within of the four traditional tests for corporate successorship. We caution you, however, that the Michigan Supreme Court has not yet addressed this issue, so the dealmakers may want to structure the deal so as to avoid liability, if possible, under the expanded version of the continuity of business enterprise test.

State Programs. As noted above, Michigan has a unique, purchaser-friendly statute which gives a new purchaser or operator the opportunity to take title or possession free of liability for pre-existing site contamination. If you are not familiar with that statutory section, we recommend that you become very familiar with Section 20126 of the Natural Resources and Environmental Protection Act (NREPA), M.C.L. 324.20126. You should also take a good look at Section 20107a of NREPA, M.C.L. 324.20107a, which provides the basis for an unwary owner or operator to back in to liability for site contamination.

Michigan is the only state which has the BEA process, but other States have programs which, while not as favorable, do offer some protection. For example,

Indiana, New York, and Kansas have established voluntary cleanup programs which may be useful to a new owner. Other states, such as Tennessee and Oklahoma, have established either formal or informal regulatory procedures under which they will issue No Action Letters. One must therefore determine what is available in a forum state. In this regard, local counsel can be extremely helpful because some of these programs are established either by administrative regulation or simply by regulatory practice, rather than by statute.

U.S. EPA offers Prospective Purchaser Agreements which may permit a new owner or operator to take over the property either free of Federal cleanup liability or with substantially reduced liability. EPA has emphasized the use of this program in recent years in order to encourage Brownfields redevelopment, but we have also found the government willing to use this program to support purchasers of general manufacturing sites. There are limitations on this program, though. First, a site must be subject to Federal enforcement action to qualify and, second, it may easily take a year to eighteen months to get a Prospective Purchaser Agreement negotiated and approved.

Insurance Coverage. In many cases, old insurance policies may provide coverage for off-site liability, especially policies issued prior to the mid-1980's. We caution you, though, that even if a policy applies and you take an assignment of the seller's rights under it, you may well have to plan on years of litigation with the insurance company to enforce the policy.

In recent years, several carriers have begun offering environmental cleanup policies to cover the cost of required on-site cleanup. In most of these cases, the policy provides stop-loss coverage, i.e., the policy applies after the insured has spent a

specified amount of money to clean up. Naturally, the amount which the insured must spend and the term of coverage, which can be up to ten years under some policies, influence the premium.

Contractual Provisions. After evaluating all these techniques to either avoid or limit the purchaser's potential environmental liability, the remaining technique is to negotiate a shift of the future environmental costs. In fact, this is done, to some extent, in virtually every Acquisition Agreement. The mechanisms and the extent to which the potential future liability is shifted, however, vary a greatly from one deal to another.

If there is major cleanup liability on-site, especially if there is a regulatory agency breathing down the seller's neck so that it is certain that there is going to be a major site remediation, the parties must face some very tough contractual questions. Will the seller retain liability for doing the cleanup? If so, it is likely that the seller's contractors will be undertaking environmental remediation on the property after the purchaser has acquired it and has begun operations on it. If a cleanup of contaminated groundwater is in the picture, the seller's contractor may be operating on the purchaser's property for 20 years or more. Can the purchaser tolerate this? Is there a quicker way to clean up the property so the purchaser can have the unlimited use of it sooner, perhaps for plant expansion? If so, will the remedial process be more expensive and will the seller be willing to foot the increased bill? Finally, if the seller is going to do the cleanup, how can the purchaser be certain that the seller will remediate to standards acceptable to the purchaser?

On the other hand, if the purchaser wants to undertake the cleanup, is the seller willing to reimburse the cost of it? How can the seller assure that the cleanup will be

cost effective if the purchaser is charging the cost back to it? How can the seller be sure that the purchaser will not remediate to Cadillac standards if a Chevrolet would have been acceptable?

We do not have readily available wisdom to answer all of these questions. They must be negotiated between the parties and the attorneys who are negotiating them are well advised to have the counsel, in the process, of competent environmental consultants to brief them on the various remedial options and the time and cost implications of each.

Suppose the purchaser prefers to do the cleanup after closing, as it usually does, and looks to the seller to indemnify it for the cost. How secure is the purchaser's claim against the seller, especially if the cleanup is a long-term process? The indemnification is only as good as the assets behind it. What guarantee does the purchaser have that the seller will remain viable or, for that matter, even remain in business throughout the term of the cleanup? At this point, of course, we turn to consideration of escrows and insurance policies.

If nobody is willing to pay the premium up front for an insurance policy, or if the parties and their consultants cannot agree on the probable cost of a cleanup in order to decide how much insurance coverage to buy, an escrow fund may be the only answer. Initially, one has the same problem of determining how much should be escrowed to cover environmental costs. The seller may suggest that a minimal sum should be quite satisfactory, while the purchaser may think in terms of seven or eight figure escrows; indeed, there may even be a risk that the long-term environmental remediation costs can exceed the purchase price for the asset.

The terms of the escrow will likely be vigorously negotiated because the seller wants to make sure that the purchaser is not extravagant in incurring cleanup costs and the purchaser wants to make sure that the escrowed funds are available for doing an adequate cleanup. Again, we have no unique wisdom or insight on these clauses. The amount of business risk that each party is willing to bear, the eagerness of each party to make the deal, and the confidence that the parties feel in the consultants' cost estimates are all factors to be considered.

Another factor that may need to be considered is whether a separate environmental escrow should be established or whether there is going to be a single escrow fund, or basket, to cover all post-closing claims. If there is to be a single escrow fund or basket to cover all claims, it is vital that the purchaser's real estate/environmental lawyer confer with the other members of the acquisition team to evaluate the risks being covered by the fund or basket. For example, if $5.0 million dollars are available to respond to all post-closing claims, but the attorney who has reviewed outstanding products liability claims, the attorney who has considered outstanding labor claims, and the real estate/environmental lawyer each feels that $5.0 million dollars should be adequate to cover all of his concerns, they may all be in for a rude shock. You simply can't take $5.0 million dollars three times out of a total $5.0 million dollar fund. Thus, coordination of the indemnity and escrow provisions is critical. This is another reason that we advise that the real estate and environmental issues be considered early in the process and that the real estate/environmental lawyer be familiar with the entire deal.

## CONCLUSION

In providing support for a corporate sale or acquisition transaction, real estate/environmental lawyers must be alert to identify many issues affecting the future operations and long term development of manufacturing plants. We must also be careful that the client is not buying substantial liabilities along with the business and the property. It is essential to have a quality environmental consultant at our elbows throughout the process.

Proper due diligence investigations take time, which must be built into the negotiation/closing schedule. Corporate deal makers, both lawyers and investment bankers, often lose sight of this fact. It is up to the real estate/environmental lawyer to educate the deal makers to the potential pitfalls and see that timely due diligence is done.

At the same time, the real estate/environmental lawyers cannot operate in a vacuum. We must understand the entire deal sufficiently so that we can see how our issues fit into the overall framework of the transaction and we must keep our deal maker partners informed as issues develop.

Resolution of real estate and environmental issues often requires hard negotiations involving the principals, real estate/environmental lawyers, the corporate lawyers, and possibly, accountants and investment bankers. The client may not make the decisions that we would have made in the circumstances, but we will have done our job if the client knows and understands the risks and the available options.