

Saving a Deal When Environmental Consultants Don't Agree

A Transaction and Environmental Insurance Case Study

By Donald C. Nanney, Esq.

When buyers and sellers need to close a deal, clashing environmental consultants can cause pessimism and confusion. However, environmental insurance can close the gap and finalize deals. This article explains how useful environmental insurance can be, by telling the story of a Gilchrist & Rutter client who recently closed a successful transaction where the seller's consultant concluded there was no "recognized environmental condition" (REC) but the buyer's consultant concluded that there was a REC and recommended extensive additional site assessment.

The transaction involved the sale of manufacturing property. The attorneys of Gilchrist & Rutter were able to complete the transaction in a manner in which both parties were satisfied with the positive outcome, by obtaining environmental insurance to cover the environmental risk without additional site assessment.

Background

The seller owned the property individually and faced potential personal liability for any environmental conditions as well as a possible threat to the transaction. The seller viewed the Phase II investigation proposed by the buyer's consultant as a fishing expedition that the seller's consultant said was not warranted. The buyer wanted to be prudent in light of its consultant's contrary advice. The transaction was going to be financed by the seller taking

back a purchase money note and deed of trust, so there was no institutional lender.

"REC": What is a "*recognized environmental condition*"?

Recognized environmental conditions include: "the presence or likely presence of any *hazardous substances* or *petroleum products* on a *property* under conditions that indicate an existing release, a past release, or a *material threat* of a release of any *hazardous substances* or *petroleum products* into structures on the *property* or into the ground, ground water, or surface water of the *property*. The term includes *hazardous substances* or *petroleum products* even under conditions in compliance with laws. The term is not intended to include de minimis conditions that generally do not present a threat to human health or the environment and that generally would not be the subject of an enforcement action if brought to the attention of appropriate governmental agencies. Conditions determined to be de minimis are not *recognized environmental conditions*." (Section 3.2.74, ASTM Standard Practice E1527-05)

As shown by the accompanying case study, environmental consultants may differ as to whether a condition constitutes a *recognized environmental condition* or is de minimis, and environmental insurance can help bridge the gap.

Purchase Agreement and Consulting Clash During Escrow

Before any purchase agreement was entered into, the seller's environmental counsel, Don Nanney, arranged for an environmental consultant for the seller to conduct a Phase I Environmental Site Assessment. The Phase I Report noted the use of tetrachloroethylene (perchloroethylene or PCE) for degreasing, but observed no cause for concern and found no REC. (What is a "REC"? See inset at left.)

During escrow, the buyer hired its own environmental consultant. Upon review of the Phase I Report and the site, the buyer's consultant treated the degreaser unit as a REC and recommended an extensive Phase II Environmental Site Assessment including soil borings and soil gas survey over much of the property. Mr. Nanney and seller's consultant were concerned especially about the proposed soil gas survey – these surveys may detect something and trigger further investigation regarding conditions and sources, even when the site owner may have no responsibility.

Continued on back.



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The purchase agreement reserved to the seller the right of approval of any Phase II scope of work. Mr. Nanney and the seller's environmental consultant suggested a narrower scope for any Phase II investigation, more focused on known suspect locations including soil sampling next to the existing degreaser unit, and no soil gas survey, at least not until initial findings demonstrated the advisability or necessity for a broader study. The buyer's consultant insisted on the broader scope in order to detect locations where PCE may have been improperly disposed of elsewhere on the property, in light of absent historical documentation of PCE use and disposal.

Resolution

First, the seller's consultant conducted supplemental Phase I research, seeking to close the gap in historical documentation of PCE use and disposition. Among other efforts, a key former employee (who knew about the degreaser operations over the years) helped find additional documentation. Even though historical documentation remained incomplete, this further research showed that PCE use had been in small amounts and generally accounted for the volume of PCE use and disposition of spent PCE.

Upon review of the Phase I addendum, the buyer's consultant did not withdraw the Phase II recommendation; rather, the consultant issued a letter finding that the environmental risk at the site was "low" (assuming that the addendum and conclusions of the seller's consultant were correct).

Second, the parties amended the purchase agreement to include an environmental insurance contingency, since the consultant's opposing opinions (as to the condition of

the property and the existence of a REC) presented an unknown, contingent risk that should be insurable. The parties disclosed the environmental studies and consulting opinions to the insurance market and obtained quotes for environmental insurance. Mr. Nanney worked with the buyer's environmental counsel and the environmental insurance broker to negotiate favorable revisions to the policy form of the selected insurer.

The parties and insurer agreed on an environmental insurance binder, obtained at closing, and the actual policy was issued later in due course. The insurance covers the buyer, seller and affiliated persons, and allows for assignment to future transaction parties, including an eventual refinance lender. The insurance covers existing pollution conditions for a 10-year term, as well as new conditions for a shorter term (since the seller's manufacturing company remains in occupancy of a portion of the property as a tenant while the seller seeks to sell the business).

The buyer paid for the policy and became "first named insured." The seller agreed to reduce the purchase price by the amount of the insurance premium. The buyer agreed to pay any deductible or self-insured retention on any claim under the policy. In order to preserve the coverage in light of the insured vs. insured exclusion, the seller and buyer signed mutual releases of environmental claims, agreeing to look only to the environmental insurance and not each other (with limited exceptions where an environmental indemnity from the buyer would remain as a backstop in favor of the seller in the event of certain other exclusions under the policy).

Thus, the transaction closed with environmental insurance in lieu of any Phase II work.

Conclusion

The transaction concluded well for both parties:

- The buyer successfully acquired property that was well located for its business needs, with transferable environmental insurance for the unknown risk, enhancing future prospects for refinancing or other transactions.
- The seller successfully sold the property with the benefit of environmental insurance and limited indemnity, avoiding Phase II testing and risk of unprotected personal liability.
- The seller's manufacturing company also became an additional named insured, obtaining protection against potential environmental liability for its past and ongoing operations, which should assist the client's sale of the business.

Mr. Nanney also handled the short-term lease to the seller's manufacturing company. This lease involved negotiations regarding environmental risk from ongoing as well as past operations, and adoption of the environmental insurance deal.

Gilchrist & Rutter's *Duane Montgomery* handled the negotiation of the seller financing documents, which had to be specially tailored in certain respects because the lender is not a typical lender (but is the former owner), and the seller's company continues in occupancy, as well as to recognize the deal regarding environmental insurance.

Contact Mr. Nanney or Mr. Montgomery at Gilchrist & Rutter with any questions regarding this case or any similar situations at (310) 393-4000.