

Real Estate, Construction And Environmental Compliance Challenges – Part I

The Editor interviews **John E. Osborn**, Partner, John E. Osborn, PC.

Editor's Note: As a result of the Sarbanes-Oxley Act, directors, management and in-house counsel of companies covered by the Act are justifiably concerned about liabilities arising from failures of compliance. Even those in organizations not covered by the Act will be judged by the courts on the basis of the new higher standards that it creates. Today, losses resulting from perceived failures on the part of management and in-house counsel are likely to be characterized as compliance failures. This can expose the directors, management and in-house counsel to significant liability.

Editor: John, your firm specializes in real estate, construction and environmental matters. How can outside counsel help corporate counsel avoid compliance problems?

Osborn: Specialized outside counsel bring to the table experience with compliance issues gained from assisting a wide range of clients. The key to defending against claims based on compliance issues is to be able to show that the practices being challenged meet the standards for "best practices." Outside counsel with practices devoted to counseling a wide range of clients about real estate, construction and environmental matters are in a position to know what constitutes "best practices" in those areas. It is helpful to be able to show that the approaches taken to resolving problems in these areas were done working with outside counsel who had been instructed that the company wanted all such matters handled in accordance with best practices.

Where the advice of in-house counsel or management might be second-guessed, it is important to be able to call upon qualified outside counsel who can attest to the fact that the actions taken were based on advice given by such counsel and were in line with best practices. This is particularly important in regard to real estate, construction and related environmental concerns where little known rules and practices abound. Environmental rules are particularly complicated. For example, anyone doing real estate development or managing a portfolio of buildings will want to check their own conclusions with those of outside counsel where they relate to a specific environmental issue such as asbestos abatement or the adoption of a program to assure compliance with environmental regulations generally. Astute corporate counsel with a good basic grounding in real estate, construction and environmental issues will promptly bring in outside counsel. This avoids mistakes that might trigger expensive litigation and costly delays.

Editor: How can outside counsel help corporate counsel judge the adequacy of insurance coverage, indemnity or security arrangements?

Osborn: Inadequate insurance coverage can trigger liability exposure. As with other sensitive decisions, technical exper-

tise and experience is essential to making the right judgments and protecting management and in-house counsel from the consequences of what in hindsight can often appear as glaring compliance failures. Here again outside counsel together with the right insurance broker can provide the assurance that the coverage selected accords with "best practices."

It is important to base the type and amount of insurance coverage needed on the recommendations of outside counsel with a wide range of experience with industry practice, coupled with an insurance broker with a good understanding of the market and the coverages available. Let's assume that the estimated cost of an environmental clean-up is a million dollars. You should get reliable advice from outside counsel and the insurance broker about whether you need to spend premium dollars to buy insurance to cover the overage in the event actual costs exceed the estimate. If you fail to get such advice, your company may face significant liability.

You need an outside counsel who not only has real estate, construction and environmental expertise, but who also has knowledge of the insurance industry. The insurance market in New York is extremely difficult. One of the reasons is because contractors' liability exposures are greater. For example, the Court's interpretation of Section 240 of the New York Labor Law knocked out certain defenses that scaffolding companies and contractors had against personal injury claims.

As a result, large contractors' premiums are extraordinarily high and many cannot get insurance without an incredibly high deductible. There are exclusions for water intrusion. The carriers require contractors to set up special work site procedures relating, among other things, to the storage of materials to make sure there is no potential mold damage. There are critical judgments to be made about the amount of the deductible and what the self-insured retentions should be.

Take another issue. Let's assume that you are buying property that may be contaminated. Should you be satisfied with an indemnity agreement? Should you also get collateral and, if so, in what amount? Here again, the advice of an experienced outside counsel who knows the marketplace can help you to evaluate the risk that the seller providing the indemnity may go into bankruptcy.

Simply put, the indemnity agreement is only as good as the collateral that backs it. Decisions on obtaining collateral are best defended if business and legal advice enters into the analysis.

Editor: Why is it particularly important to involve outside counsel in compliance issues arising under local laws like the New York law relating to façade repairs?

Osborn: As an example, under New York



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City Local Law 11, building façades must be inspected every five years. If a façade starts to deteriorate, in-house counsel would probably recommend that someone do an inspection and then hire an engineer to sketch out what needs to be done to repair the façade. Your biggest concerns are finding the right firm to design and implement the repairs to that type of façade and then getting a contract drafted that properly expresses the terms, including how the risks are allocated.

But other issues are important too. Should the engineer be held responsible that the design will work or simply for sketching it out? How is it bid? What kind of package goes out to the contractor? These are frequently issues with which most corporate counsel do not have extensive experience.

Façade repair jobs often end up in litigation. Getting it right in the documentation can help reduce the risk of litigation. You have to be sure that the contracts and the types of assurances are right. For that type of job, the responsibilities of each participant (i.e. contractor and engineer) have to be clearly spelled out. Outside counsel can advise how this should be done. If litigation develops, it is always helpful to be able to call upon outside counsel to confirm your compliance with best practices as they relate to façade repairs. We have been involved with large façade jobs where extensive work was done and the façade is still experiencing cracks. Construction defects and design errors are often experienced with this type of work. It is essential that the design professional and contractor be chosen carefully and selectively and that the contracts entered into protect the owner. Outside counsel can help reach both of these goals.

Editor: What about failures with respect to the inclusion of appropriate representations and warranties in the documents involved in a real estate or construction deal?

Osborn: In every transaction involving the sale of property or services, the seller's and buyer's attitudes toward the representations and warranties are quite different, but for both, getting them right is vital. Failure to receive the right warranty or giving a warranty that creates unnecessary liability can cause great and inappropriate loss to the client. Failure of in-house counsel on this issue can result in significant liability to the company that could have been avoided at the outset with the right advice.

Corporate counsel should bring in outside counsel to review the representations and warranties in important transactions to minimize the risk of such a failure. Over the years, outside counsel accumulates a knowledge bank of experience upon which to draw in determining the relative importance of particular representations and warranties — and when they should be included. However, any advice by outside counsel is only meaningful if outside counsel has first gained a thorough and comprehensive understanding of the transaction beginning with an examination of the building and property assessments and any structural or environmental aspects, including how the building was used by

prior owners and how the client intends to use the premises.

Editor: How can outside counsel help corporate counsel convince the client to conduct an appropriate level of due diligence?

Osborn: When management set their minds on purchasing a property, they frequently do not want to hear reasons why they should not immediately rush out and clinch the deal, particularly where the necessary due diligence is costly and time consuming. The cost of environmental due diligence can range from a couple of thousand dollars to up to \$50,000 on a larger property.

Purchasers tend to shy away from anything beyond a Phase I assessment. That is a visual assessment and involves looking at property records. Phase II includes a boring to see whether there are tanks or other sources of contamination beneath the surface. Litigation addressing leaking underground tanks that were not anticipated prior to closing is not uncommon. This problem often could have been avoided if the purchaser had been willing to spend appropriately for pre-purchase due diligence. In-house counsel can be much more persuasive with management if they ally themselves with outside counsel who can cite examples of the dangers of proceeding without appropriate due diligence and can point out the potential liability of management for not complying with what has become a best practice in the industry.

Editor: How can an experienced outside counsel assist in detecting the presence of corruption and setting up procedures to minimize it?

Osborn: Although significant steps have been made to address corruption in the New York construction industry, it remains a problem that must be addressed. If a program to address integrity compliance issues is not in place, the corporation and its management face potential criminal liability. At the least, losses from failures to have adequate compliance programs could expose directors, management and in-house counsel to civil liability.

Here again, involvement of outside counsel is prudent. Experienced outside practitioners are aware how to structure integrity programs. They can help identify integrity programs that will train employees in ethical conduct and in recognizing the indicia of corruption, and they can provide advice with respect to hot line arrangements that will enable employees to report suspicious circumstances.

Outside counsel can help set up ways to make procedures for selecting contractors and making contracting and contract administration less vulnerable to corruption. In this way, closer scrutiny would be devoted to method of contracting and to the change order and payment process. There would be background checks of the bidders, including examining records of corruption or violations of law, such as failure to pay prevailing wages on a job. Although the screening may add additional expense, it is money well spent.

Please email the interviewee at josborn@osbornlaw.com with questions about this interview.