Avoiding A Quagmire
Environmental and Product Liability Issues

The year 2006 will be remembered as one of the most active years for mergers and acquisitions. These mergers and acquisitions all involve some form of due diligence where in-house counsel are under increasing pressure to find out, before the transaction closes, where hidden liability “time bombs” may lie. In order to serve your client effectively, your search for these “time bombs” must include a review of the environmental and product liability matters that are part of most corporate transactions. In the past, these hidden problems were usually minor or manageable. Often they led to insurance issues that required added liability protection or disclosure on SEC filings and shareholder materials. However, if not managed appropriately or identified early enough these liability problems can result in a blown deal or even bankruptcy proceedings. In addition, as the plaintiffs’ bar has become better funded and more sophisticated, large corporations have become more vulnerable targets for class action lawsuits.

If you are a member of the corporate legal staff of a company engaged in or considering corporate acquisitions, awareness of the potential environmental and product liability issues affecting an acquisition are crucial. Not only must you be aware of the law, but also there are practical implications for every acquisition which in-house legal counsel need to keep in mind. This article provides suggestions for in-house counsel on how to conduct a proper due diligence for the hidden environmental and product liability implications of a corporate acquisition.

The following fact pattern is illustrative. Company B purchased the assets and product line of a subsidiary of Company A, a large Fortune 200 conglomerate. Company B, as part of the acquisition agreement, did not assume liability for Company A’s subsidiary’s products, and Company A agreed to defend, indemnify and hold harmless Company B for any potential liability. Company A’s subsidiary was dissolved after the asset purchase. Company B, believing it was adequately covered by the comprehensiveness of the indemnification, did not acquire Company A’s (or its subsidiary’s) insurance policies or acquire gap coverage.

Unfortunately, Company A had manufactured asbestos containing products during its lengthy corporate existence. Within five years of the asset transfer, Company A had been sued in over 5,000 asbestos cases nationwide and made the business decision to seek Chapter 11 bankruptcy protection. Meanwhile, Company B was sued for personal injuries resulting from a product manufactured by Company A’s subsidiary before the asset transfer. Company B was stuck with no insurance and a claim in bankruptcy on the indemnification agreement.

A. THE LEGAL LANDSCAPE:
Whenever a corporate transaction occurs, the form of transaction will determine what liabilities follow the assets being transferred. A quick review of the different forms of transactions and the effect the form of the transaction has on the liabilities assumed follows. Also discussed below are the more expansive rules for liabilities assumed on product liability and environmental claims as compared to most other liabilities or claims transferred in a corporate transaction.

1. The form of acquisition usually dictates the liability assumed
Several different transactional techniques exist for corporations to combine the operations of two or more companies or to sell part or all of a corporation’s products. These techniques include mergers, takeovers and various forms of asset or stock purchases. In certain instances, a court will look beyond the form of the acquisition chosen by the parties and determine that, despite
the parties’ intentions, the acquisition was a de facto merger. The form of the acquisition usually determines what liabilities the purchasing corporation assumes.

The traditional rules of corporate liability provide that a corporation purchasing assets for cash is not liable for the conduct, acts and/or products of the seller. There are, however, four traditional exceptions to this general no-liability rule. The four traditional exceptions to the general rule are:

- The successor expressly agrees to assume the predecessor’s liabilities;
- The assets sale amounts to a de facto merger;
- The purchaser is a mere continuation of the seller; or
- The sale is for the fraudulent purpose of escaping liability from the seller’s obligations.

Ray v. Alad Corp., 19 Cal. 22, 28 (1977). These traditional rules apply throughout the United States. However, as noted below, some states have additional exceptions which can expand the liabilities passed from buyer to seller. One or more of these traditional exceptions may apply in a corporate acquisition context, and will likely depend upon the type of acquisition made.

a. Mergers, Hostile Takeovers, Asset Purchase Agreements and De Facto Mergers

A merger between two corporations results in the assumption of the liabilities of the former entities by the newly formed entity. Thus, in a merger, or a hostile takeover, the acquiring or resulting corporation typically assumes all the liabilities of the former entity. Some corporations, in an effort to avoid assuming all the liabilities of a target or partner corporation, will agree to only purchase the seller’s assets, rather than merge with the seller. Conversely, in a purchase of assets situation, liabilities of the selling corporation normally are not assumed unless done so expressly in the asset purchase agreement.

There is also the “de facto” merger which occurs when an assets sale is found to be essentially the combining of two corporate entities into one, as in a typical merger. Courts generally consider five factors when determining whether a transaction cast as an assets sale or other corporate combination results in the same practical effect as a merger. The factors are:

1. whether the consideration paid for the assets was solely stock of the purchaser or its parent;
2. whether the purchaser continued the same enterprise after the sale;
3. whether the shareholders of the seller became shareholders of the purchaser;
4. whether the seller liquidated;
5. whether the buyer assumed the liabilities necessary to carry on the business of the seller.

b. The “Continuation” Exception

Applying this traditional exception, courts evaluate whether the successor uses the same name, employees, property, etc. as the predecessor and whether there is a commonality to the management and ownership of the two entities. The decision by the Michigan Supreme Court in Turner v. Bituminous Casualty Co. expands the traditional “continuation” exception by finding a successor liable in the context of an asset sale for cash. In Turner, a defendant had purchased another corporation’s assets for cash and formed a subsidiary into which the corporation was placed. Four days after the sale, the seller dissolved and the subsidiary continued to operate. After several years, the subsidiary merged into its parent. The plaintiff sued both the parent and the subsidiary. The trial court held the defendants not liable for a product manufactured by the dissolved seller. The Michigan Supreme Court, however, found that there should be no difference with respect to successor liability between a sale for cash and the transfer of stock. Id. The court emphasized that liability should be imposed on a successor where there is continuity between the transferor and the transferee corpo-

1 The mere continuation exception requires a finding of one or both of the following elements: (1) no adequate consideration was given to the predecessor for its assets and thereafter made available for meeting the claims of unsecured creditors; (2) one or more persons were officer, directors, or stockholders of both corporations. Ray v. Alad, supra, at 29; Maloney v. American Pharmaceutical Company, 207 Cal. App. 3d 282 (1988) (plaintiff filed a products liability action against defendant, alleging that defendant was liable as a successor to a bankrupt corporation that negligently manufactured a pharmaceutical drug, causing her injury. The successor corporation had purchased 10% of the total liquidated assets of the predecessor. The court found that there was no evidence that the money paid was insufficient or invalid consideration. The court also noted that the other characteristics of a mere continuation were absent, i.e., the transaction was not a sale of the predecessor’s principal assets, the sale was not a direct sale from the predecessor to the successor, and the transaction did not involve the continuity of employees beyond a single officer.)

Quagmire

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such continuity existed between the defendants and the predecessor from evidence that:
1. purchaser maintained similar products, policies, personnel, and shareholders as the transferee;
2. seller dissolved four days after the sale;
3. purchaser assumed the liabilities of the seller ordinarily necessary to continue business operations;
4. the purchaser held itself out to the public as a continuation of the seller.
The Turner holding, known as the “continuity of enterprise” exception, expands the possible liability of the successor by also looking at the effects of the sale on the predecessor. This Michigan holding has been considered and/or adopted in Alabama, Michigan, New York, New Jersey, Ohio, and Pennsylvania. The majority of jurisdictions, however, do not accept the expansion of the mere continuation exception in situations where the assets are purchased for cash. These jurisdictions generally reject the Turner holding, maintaining the traditional rule that a de facto merger requires the transfer of stock.

c. Asset Purchase Agreements and the Product Line Exception
An acquiring or purchasing corporation in an asset purchase agreement only assumes the seller’s liabilities specifically identified or if the asset sale is subject to one of four traditional exceptions. In the influential case of Ray v. Alad, however, the California Supreme Court created the “Product Line Exception.” This fifth exception to the general rule that liability does not follow the buyer, holds that a successor corporation that purchases a “product line” from a predecessor can be held strictly liable for product defects caused by its predecessor corporation. The case significantly expands the possible liability of a successor corporation.

In Ray, the plaintiff was injured when he fell off a defective ladder manufactured by the Alad Corporation (Alad I). By means of a cash transfer, the successor corporation (Alad II) acquired all the assets of Alad I, including the Alad name and products (ladders). Alad II continued to manufacture the same product line, using the same name, equipment, designs, and personnel, and soliciting Alad I’s customers through the same sales representatives with no outward indication of any change in the ownership of the business. The purchase agreement expressly provided for the dissolution of Alad I “as soon as practical.” Accordingly, Alad I was dissolved two months after the transfer.

The Ray court found that none of the four traditional exceptions to the non-liability rule (discussed above) applied to the facts. Consequently, the court went on to create the “product-line exception,” to impose liability on Alad II. The court set forth three criteria necessary to impose liability on a successor corporation based on the product-line exception:

1. The virtual destruction of the plaintiff’s remedies against the original manufacturer caused by the successor’s acquisition of the business;
2. The successor’s ability to assume the original manufacturer’s risk-spreading rule; and
3. The fairness of requiring the successor to assume a responsibility for defective products that was a burden necessarily attached to the original manufacturer’s good will being enjoyed by the successor in the continued operation of the business.

Applying these criteria to the facts of Ray, the court found that the plaintiff’s remedies were ultimately destroyed by the sale of assets to Alad II because the purchase agreement required Alad I to dissolve “as soon as practical” and Alad I did, in fact, dissolve two months after the transfer. With respect to the second criteria, the court found that the transaction involved the

3 See Diaz v. South Bend Lathe Inc., 707 F. Supp. 97 (E.D.N.Y. 1989) (imposing liability on successor who purchased assets for cash on the grounds that predecessor ceased business operations after the sale and shareholders voted to dissolve the predecessor as soon as possible ).
4 See Ruiz v. Benetech Corp., 89 F.3d 320, 325 (7th Cir. 1996) (applying California law and finding that asset sale was not a de facto merger because seller received cash, not stock, and seller’s shareholders did not participate in the ownership of buyer); see also Franklin v. USX Corp., 87 Cal. App. 4th 615 (2001) (holding that asset sale in exchange for cash was not a de facto merger absent evidence that money paid was insufficient or inadequate consideration).
5 The second requirement in the Ray analysis is a finding that the successor is capable of assuming the original manufacturer’s risk. In Ray, the court relied on evidence that the successor corporation acquired the successor’s physical plant, manufacturing equipment, inventories of raw material, works in process, finished goods, designs, continued employment of the factory personnel, and consulting services of the predecessor’s general manager. Id. Based on this evidence, the court found that the successor corporation had the same capability of assessing the risks of potential claims of liability for product defects and spreading the risk among its customers.
transfer of the manufacturing plant, the equipment, and inventories, work in process, finished goods, manufacturing designs, and the continuing employment of personnel. The continuation of the business provided Alad II with the same capacity to assess the risk of possible claims of injury, thereby giving it the opportunity to obtain insurance or otherwise insulate itself from risk.

Finally, the court found that imposing liability was fair and equitable in light of Alad II’s exploitation of Alad I’s established business, it should shoulder the burden of potential liability arising from defective products manufactured by the acquired business.

Although the holding in *Ray* greatly expanded the scope of successor liability, the court also repeatedly emphasized that the exception applied “under the narrow circumstances here presented . . . .” However, some California courts have applied the *Ray* exception liberally, while others have limited its application.

The *Ray* exception remains in the minority. Few jurisdictions that have considered the expansion of the no-liability rule have adopted it. Those jurisdictions in which liability can be imposed on a successor corporation’s continuation of a product line include California, New Jersey, New Mexico, Pennsylvania and Washington.

2. Indemnity and insurance contracts and policies

Under most circumstances, selling companies will negotiate an indemnity agreement with the purchasing company. These indemnity agreements will provide for liability coverage during certain periods of time prior to the purchase. These indemnity agreements must be closely scrutinized to assure that all possible liabilities are covered. An indemnity agreement may reference insurance contracts and/or policies as the basis for the liability coverage. The acquiring company must also obtain, review and preserve copies of these policies should liability arise at some point in the future.

For example, the authors are aware of a number of instances where either the policies or the indemnification agreements ultimately proved to be worthless. The example provided at the opening of this article is just one such instance that in-house counsel must consider.

3. Regulatory and environmental obligations

Corporations must be aware that the smoldering problem of hidden liabilities can also exist with respect to environmental liabilities. These liabilities must be fully investigated before corporate acquisitions are made. In-house counsel need to investigate environmental liability and compliance history under local, state and federal laws and regulations. Moreover, in-house counsel must ensure that the necessary environmental professionals, typically hydrogeologists or environmental engineers, are actively engaged in the due diligence process. Advice from environmental professionals is critical to a risk analysis for a proposed acquisition. Informed professionals

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6 The *Ray* court based the third element of the product-line exception on equitable grounds, finding that the imposition of liability on a successor was fair and just when the successor enjoyed the benefit of using the predecessor’s trade name, goodwill, and customer lists, and held itself out to the public as the same enterprise. *Id.* at 34. The court reasoned that the successor must bear the burden of liability when it obtains the benefit of the predecessor’s established reputation and goodwill. By continuing the predecessor’s business, the court reasoned, the successor should bear the cost of injuries resulting from its predecessor’s defective products. *Ray* v. *Alad*, at 31.

7 *Id.* at 25; see also *Id.* at 31, 34; see *Fish v. Amsted Industries*, 126 Ws. 2d 293, 305 (1980) (criticizing the product-line exception developed in Ray on the grounds that the successor corporation did not create the risk, did not directly profit from the sale of the defective product, did not solicit the use of the product, nor make any representations as to its safety).


9 In a Ninth Circuit opinion discussing the first factor in Ray, the Court required that the plaintiff both lack an effective remedy against the predecessor corporation, and that the sale of assets cause or at least contribute to the dissolution of the predecessor, thereby eliminating the plaintiff’s potential recovery. See *Kline v. Johns-Manville*, 745 F.2d 1217 (9th Cir. 1984) (sale of predecessor’s assets did not cause predecessor’s bankruptcy). The court found that the predecessor sold the entire product line, customer lists, and trade name to the defendant, who continued manufacturing the alleged defective product for ten years. After plaintiffs filed their claim against both the predecessor and successor, the predecessor filed Chapter 11 bankruptcy. The court addressed the successor’s liability, finding that after the successor’s purchase of the defective product line, the predecessor remained a viable defendant, and continued to do business as a large corporation. The court reasoned that if there had been no sale of the product line, the plaintiffs would not be in any better position because the predecessor filed bankruptcy twenty years after the sale and for reasons unrelated to the sale. Therefore, the court found that the plaintiffs had the right to file claims against the predecessor in the bankruptcy proceedings.

10 See *Restatement (Third) of Torts § 12*. 

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Quagmire

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can assist in-house counsel to educate Company management on whether or not an environmental liability is manageable. Although certain closure plans and remedial activities can last years or even decades, the actual annual expenses associated with managing those liabilities may fall within a company’s tolerance level for risk and expense.

a. CERCLA Liability

The Comprehensive Environmental Response, Compensation and Liability Act (“CERCLA” or “Superfund”) has been the primary driving force for clean-ups at inactive or abandoned contaminated sites for the last 25 years. 42 U.S.C. § 9601 et seq. Superfund liability is perhaps the highest profile, or at least the most commonly known, potential environmental liability that is typically reviewed by an acquisition due diligence team. That notoriety is well deserved as CERCLA is a uniquely imposing statute that can hold Potentially Responsible Parties (PRP) jointly and severally liable, and that liability can be applied retroactively. Most states have enacted similar statutes and in-house counsel need to thoroughly consider the varying state laws and clean-up requirements as part of any environmental due diligence.

In many circumstances, corporations can be found strictly liable for any hazardous waste found on their property, regardless of whether they or a predecessor was responsible for the actual release to the environment. See, e.g. Farmland Industries, Inc. v. Morrison-Quirk Grain Corp., 987 F.2d 1335 (8th Cir. 1993). In other words, liability under CERCLA is not necessarily based upon whether the successor corporation caused or released the hazardous material, but may be the simple fact of whether or not the successor corporation is the current legal owner of the contaminated property. Under CERCLA, generally, an acquiring corporation can be identified as a PRP when it is considered to be the successor to: 1) a current or former owner or operator of a site; 2) a generator of waste at the site; 3) a transporter of waste to the site; and as 4) an arranger of transportation or disposal of material at the site. Thus, in addition to the liability associated with buying a contaminated piece of property, in-house counsel should also consider identifying the past environmental practices of the acquisition target, including the service providers and disposal sites that were utilized. This can prove to be quite a challenge and because of the retroactive application of CERCLA, it is a significant area of hidden liability. That is, a successor can be found liable even if the acquired company lawfully disposed of the material at the time. In many cases, that activity may have occurred decades ago. Obviously, even the most thorough due diligence of an older site could fail to uncover this type of unknowable liability.

Even though a successor corporation can be saddled with predecessor liability under CERCLA, the successor may have a right of contribution from the predecessor corporations who actually caused the releases. Frequently, however, the predecessor corporations or owners are insolvent, no longer exist, or have entered bankruptcy which may leave the successor corporation with the entire bill for remediation. If one or more predecessors do exist, certain courts have applied the state common law to determine whether successor liability exists for contribution. See Atchison Topeka and Santa Fe R.R. v. Southern Pacific Trans. Co., 159 F.3d 358 (9th Cir. 1997).

In January 2002, CERCLA was amended to provide liability protection for certain property purchasers and landowners. The amendment required bona fide prospective purchasers, contiguous property owners and innocent landowners to conduct “all appropriate inquiries” into prior uses of a property before proceeding with the purchase in order to receive liability protection. Until recently, there has been very little guidance regarding what all appropriate inquiry actually means in practice. In November 2006, the EPA All Appropriate Inquiry Rule (“AAI Rule”) went into effect and helps answer the question of “how much due diligence is enough”. While very similar to existing methodologies, the AAI rule is more robust than historical due diligence requirements and expands the scope of standard Phase One property assessments. The AAI Rule also addresses reliance on and the transferability of prior environmental assessments, generally establishing one year as the shelf life for most assessments, although it does identifies some assessment components, like personnel interviews and visual inspections, which must be done with six months.

The AAI Rule was promulgated to clarify when a party could invoke a CERCLA liability defense, although the AAI Rule is likely to become the standard for due diligence in future commercial trans-

actions. If your company acquires property in a transaction, the due diligence of the property should be done in accordance with AAI Rule. The transferring of PRP liability is common in mergers and acquisitions and is usually spelled out clearly in the agreement. The agreement may require that all CERCLA liability be assumed or excluded or it may specifically list certain state or federal Superfund sites in an exhibit. However, typically the transferring of liability is purely contractual and CERCLA makes no provision for allowing for one party to contract its way out of Superfund liability. If a company is found to be a responsible party, assumes the status of a PRP through merger, acquisition or hostile takeover, or is deemed to be a successor corporation under the analysis discussed above, that company will probably always remain a PRP under CERCLA and state equivalent statutes. For in-house counsel that means the obvious: the indemnity provisions of the agreement and financial strength of the indemnitor will ultimately determine responsibility for Superfund liabilities.

b. Operational Liabilities

In addition to CERCLA liability, there are a myriad of environmental laws, rules and regulations that govern operations at an industrial or manufacturing facility, and many can impose significant liabilities on successor corporations. The focus of these statutes is regulating the conduct of pollution generating activities or identifying the scope of industrial or manufacturing processes. Successor liability under environmental laws depends on the individual state’s laws regarding corporate liability, but the general principles identified in this article apply. Although there are numerous operative statutes, three of the primary federal laws that can give rise to operational liability are the Resource Conservation and Recovery Act (RCRA at 42 U.S.C. § 6901 et seq.), the Federal Water Pollution Control Act (commonly referred to as the Clean Water Act at 33 U.S.C. § 1251 et seq.) and the Clean Air Act (at 42 U.S.C. § 7401 et seq.) Each statute sets forth a regulatory framework under which regulated companies must operate, monitor and report to the regulators. The operational control mechanism under these statutes, as is the case with most environmental laws, is a permit or license granted by a governmental agency.

If a company desires to acquire a facility and significantly change its processes or operations, the acquiring company must be aware of what is allowed under the target facility’s operative permits. Most changes to a permit will require a formal permit modification and depending on the extent of the requested change, the modification process can be time consuming and expensive. While most permits and licenses are readily transferable, they also expire and must be renewed. In many agreements, tremendous value is placed on the operating permits, and a due diligence team must know how long the permits will remain active and understand exactly what is involved in the renewal process.

While many states have taken the lead on implementing environmental policy and enforcing environmental regulations modeled after the federal system, it is often a local county or municipal regulatory agency that ultimately grants precious operating authority to industrial and manufacturing facilities. Additionally, many cities or counties may require strict environmental permits for air or water quality reasons that are in addition to all applicable state or federal requirements. In-house counsel would be remiss in failing to see the importance of local operating authority or local permit conditions when evaluating an acquisition target.

An important concept for in-house counsel to note is that the operational and compliance history of a facility run with the facility, and changing a name or legal entity, will not eliminate or significantly alter the responsibilities and obligations owed to the surrounding community or regulatory authorities. Most industrial facilities have multiple permits, each with specific guidelines, operating parameters and restrictions. In-house counsel must ensure that the due diligence team familiarizes themselves with the facility permits and operations because the permits also likely run specifically with the site, not the corporate entity. Therefore, understanding historical operations and maintaining or capturing some level of institutional memory are key goals for a company seeking to understand inherited or purchased liabilities.

B. PRACTICAL CONSIDERATIONS FOR ENVIRONMENTAL AND PRODUCT LIABILITY DUE DILIGENCE

1. Product Liability Due Diligence

Each transaction has issues and concerns unique to it. However, many transactions involve similar issues and the authors offer the following suggestions. It should be noted that the suggestions and recommendations are illustrative and not exhaustive.

When acquiring assets of a prior corporation, it is advisable to obtain and preserve certain documents to protect against future liability. Documents produced and maintained by the risk management department can be particularly helpful in defending your company against future suits. Also, as mentioned in the example...
above, documentation of prior insurance coverage can be invaluable in preventing a liability, or failure of indemnity, disaster.

Also, find out whether the company being acquired has a full library on all existing products manufactured and distributed by the company, as well as those that have been manufactured and distributed in the past five years (at least). These files should include manufacturing specifications, component part supplies, design changes, names and current addresses of key individuals involved in the design, manufacturing, marketing, supply, and advertising areas. Consider entering long-term consultation agreements with former key employees, and identify those potential former employees who may provide information to competitors or plaintiffs attorneys.

Identify all existing insurance policies for a minimum of 25 years, including both primary and excess policies. Consider whether retaining an insurance archeologist, a specialist in locating and reconstructing insurance assets, might be of value. Perform a risk management evaluation to determine whether additional insurance is necessary, and at what cost.

Review the claims history with regard to the company s products, and establish a chain of command for the handling of any individual lawsuits which are currently pending or anticipated. If necessary, consider the retention of national coordinating counsel for purposes of maintaining corporate documents, and consistency in responding to discovery on a nationwide basis.

2. Suggested Environmental Due Diligence

Investigate all manufacturing sites for potential sources of contamination of surface soils, ground water, air, and/or surface waters, and understand any offsite impacts. Identify key environmental engineering personnel from each site, consider potential retainer agreements and ensure that information is systematically gathered from these individuals. Ask these individuals to assist in confirming the status and life expectancy of all operational permits and licenses.

Identify any and all insurance policies that might cover environmental recovery costs from either government claimants or private litigants. Consider conducting a full environmental audit once acquisition has been completed in order to determine the potential for future claims or clean-up expenses. Review compliance history for industrial or manufacturing sites, identifying profiles of environmental service providers and understanding historical waste management policies and practices.

The above recommendations are cursory and not intended to be exhaustive, but they can serve as a foundation upon which in-house counsel build a due diligence analysis of environmental and product liability issues affecting a corporation involved in the acquisition of others. While investigating these potential sources of problems is necessary, there is no guarantee that even a full and complete review will safeguard the company against all eventualities. However, by going into a merger or acquisition with their eyes wide open, in house counsel can certainly limit the potential for disaster that hidden liabilities can represent.

C. CONCLUSION

Long-term corporate strategies include the acquisition of competitors and complimentary companies. The structure of the acquisition is based on many different factors, such as the willingness of the acquiree to be purchased, tax considerations, operational synergies and financial feasibility. In many instances, environmental and product liability implications are taken into consideration only after the form of the agreement has already been agreed to, or after the acquiring company has already made a firm decision to acquire the competitor and/or complimentary company. The authors of this article suggest that product liability and environmental concerns should be placed at an even level of interest and concern as long-term strategic interests and tax considerations. Taking into consideration the problems of product liability and environmental concerns sometimes will affect the company only marginally. However, failure to take these issues into consideration may result in dire consequences to the acquiring company.

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The authors would like to acknowledge the assistance of Nathaniel S. Currall, an associate in the Los Angeles office of Kirkpatrick & Lockhart Preston Gates Ellis LLP.