

ENERGY & ENVIRONMENT

Warning: Frivolous Signage Ahead

By Lisa L. Halko

“WARNING: This area contains chemicals known to the State of California to cause cancer, or birth defects or other reproductive harm.” You have walked by that sign today: in a hotel lobby, in a parking garage, at the gas station, at the drug store, at the dentist. Unless you just arrived from out of state, you probably don’t notice it any more. Technically, the signs are true — but they are not informative. Do you need to be told that there’s engine exhaust in the parking garage? Gasoline at the gas station? Do you need to be told that breathing too much engine exhaust might not be good for you, especially if you’re pregnant? No. The signs are there not to protect you but to prevent frivolous litigation against the businesses that post them. Diesel and gasoline exhaust are among more than 800 substances on California’s list of “chemicals known to cause cancer or reproductive toxicity,” creating a cause of action against anyone with 10 employees and a parking lot.

That is not what most people thought they were voting for when California passed Proposition 65, the Safe Drinking Water and Toxic Enforcement Act of 1986. The ballot arguments in favor said it would protect drinking water supplies, and require warnings if people’s cancer or birth-defect risk would be increased by exposure to “toxic chemicals.” Deciding which chemicals are toxic would be “based strictly on scientific testing,” because the law “does not apply to insignificant (safe) amounts of chemicals.”

That didn’t happen. Municipal drinking water is as clean and safe as it has ever been, but it is exempt from Proposition 65. And instead of warnings about real risks, we got signs telling us things we already know.

We also got signs telling us things that aren’t true. For example, electrical cords have small amounts of lead in them — not enough to hurt anyone, unless you plan to grind them up and sprinkle them on your oatmeal every day for the rest of your life — but a detectable amount. Thanks to Proposition 65, they have warnings telling you that they cause cancer and birth defects. Well, they don’t. Lead is a public health problem when children eat it in paint or play in soil contaminated by exhaust from leaded gasoline. The elimination of lead-based paint and lead-based gasoline has drastically reduced lead poisoning from those sources. But Proposition 65 didn’t do that. Public health regulation based on true risk-benefit analysis did that.

Proposition 65 proliferates warnings because a trace amount of a suspect chemical is sufficient to constitute a prima facie “exposure.” The defendant

bears the burden of proving that the amount is insignificant. Under Proposition 65, an exposure is “insignificant” if a person could take in that much of the chemical every day for a lifetime without an increased cancer risk, and could take in 1,000 times as much without any reproductive effect. No matter how safe the electrical cord, it’s easier and cheaper to place the warnings than to prove that in court with expert testimony. Businesses post Proposition 65 signs just so that plaintiffs cannot accuse them of “exposing” people to everyday chemicals without a warning. The law is particularly hard on retailers, who bear the risk of selling products that they do not make.

Businesses that get caught without warnings receive notices from private attorneys who sue for civil penalties and attorney fees. Since all the exemptions are affirmative defenses requiring expensive expert testimony, most cases settle. Under Proposition 65, the private plaintiff gets to keep one-fourth of the civil penalties (which is why they are also called “bounty hunters”), but the real money is in attorney fees. Of the \$11.8 million in Proposition 65 settlements that businesses paid in 2007, less than 20 percent was for civil penalties. More than half was for attorney fees, and the rest was for payments “in lieu of civil penalties.”

Another common settlement term is “product reformulation.” Instead of placing a warning on the product, businesses agree to reduce the amount of a chemical from one miniscule amount to a slightly smaller miniscule amount. Those electrical cords, for example: the ones without warnings contain about 200 parts per million lead. The ones with warnings contain about 600 parts per million lead. It makes no difference to anyone’s health, but it allows plaintiffs to claim that they have “made products safer” through litigation. Meanwhile, costs go up because manufacturers and importers must switch from recycled plastics that contain lead at the old levels, to new materials with marginally less.

Has anyone considered whether the excess costs are worth it? No. Proposition 65 policy assumes that if something can harm you at high levels, it should be eliminated completely from commerce. That’s obviously false. Consider hydrogen oxide, also known as water. In its gaseous state, it causes severe burns (e.g. from the spout of a teakettle). Inhaling it can kill you. But in smaller quantities, it is necessary for life, health and cleanliness. Banning it from commerce would be a bad idea.

Similar is dibutyl phthalate, also known as DBP, which is a plasticizer. Adding small amounts of DBP to plastic film, paint, lacquer or caulk makes a prod-

uct more flexible so that it doesn’t chip or crack. It doesn’t migrate from the products because of the shape of the molecule. It is perfectly safe for those uses. But it is listed under Proposition 65 as having “reproductive effects” because, if you feed enough of it to pregnant rats, some of their male offspring will have “reduced anogenital distances” at birth. There is no evidence of any effect on human beings from DBP.

Shortly after DBP was listed, California passed AB 1108, which bans DBP and five other phthalates from toys. AB 1108 followed earlier examples of bills banning Proposition 65-listed chemicals, such as AB 1681, which enacted word for word a Proposition 65 settlement on lead in jewelry. The ban is prohibitively difficult for retailers because phthalates are used in many plastic toys, which retailers purchase from thousands of vendors. Chemical testing for phthalates is very expensive, and for it to be accurate the product must be destroyed.

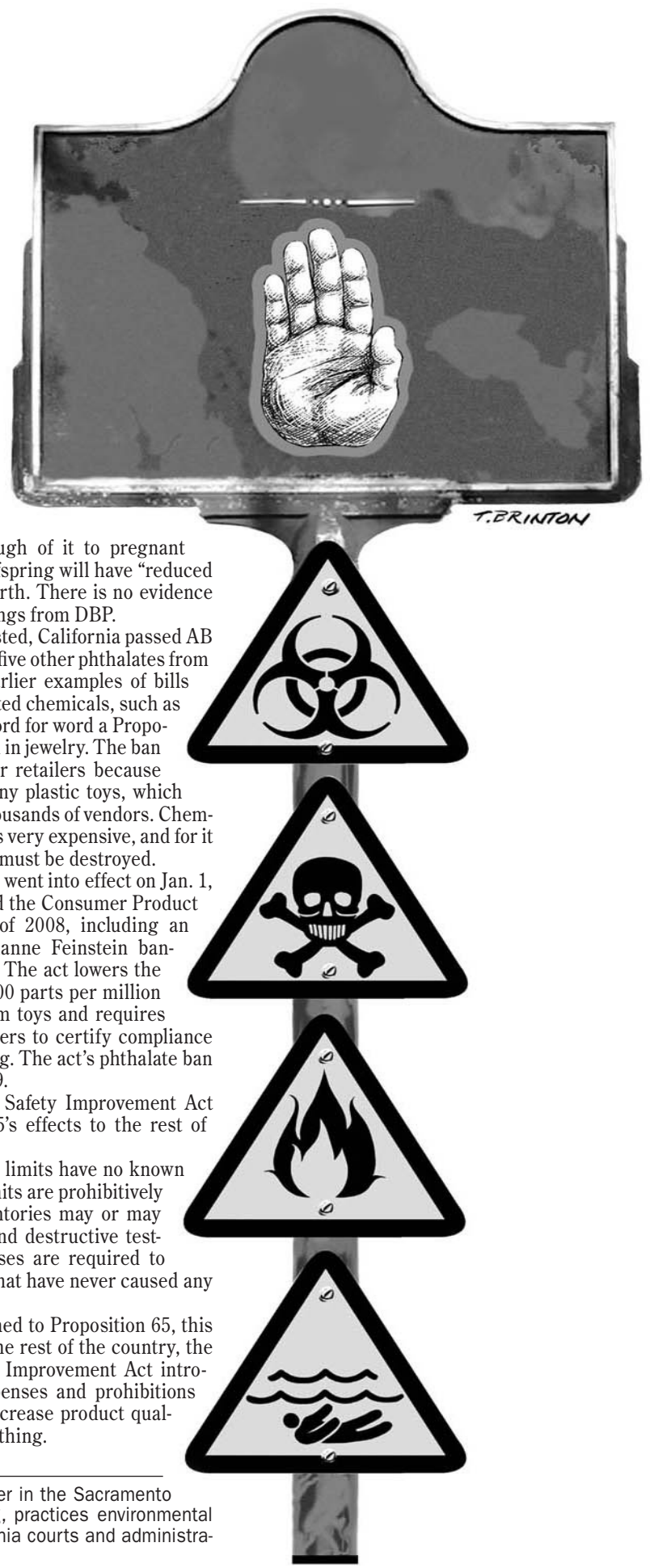
By the time the DBP ban went into effect on Jan. 1, 2009, Congress had passed the Consumer Product Safety Improvement Act of 2008, including an amendment from Sen. Dianne Feinstein banning phthalates from toys. The act lowers the lead limit for paint from 600 parts per million to 90, bans phthalates from toys and requires manufacturers and importers to certify compliance based on third-party testing. The act’s phthalate ban took effect on Feb. 10, 2009.

The Consumer Product Safety Improvement Act generalizes Proposition 65’s effects to the rest of the country:

The new, “reformulated” limits have no known public benefit. The new limits are prohibitively expensive. Retailers’ inventories may or may not meet the new limits and destructive testing is expensive. Businesses are required to prove safety for products that have never caused any harm.

For businesses accustomed to Proposition 65, this is business as usual. For the rest of the country, the Consumer Product Safety Improvement Act introduces California-style expenses and prohibitions that increase costs and decrease product quality while accomplishing nothing.

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Lawyers Will Play a Direct Role in Developing Clean Tech Industry

By Peter Buckland

Most people understand the big picture: Clean technology offers the country an opportunity to create jobs, reduce our dependence on foreign energy sources and fight global warming. What is not so obvious is how clean technology is influencing the legal profession, specifically the provision of legal services to companies, the expertise that clean technology-focused clients require and what role lawyers currently play and can play in this industry in the future.

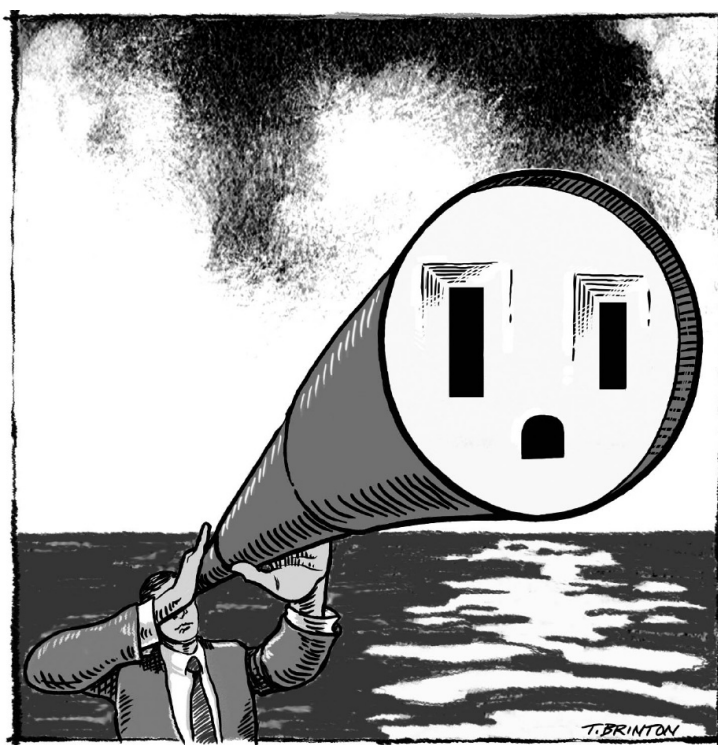
To understand the influence that clean technology is having on the legal industry, all you need to do is pick up a newspaper, turn on the television or enter the home page of almost every large law firm. Clean technology is everywhere. Clean technology encompasses multiple business sectors, including energy efficiency solutions, the smart grid, the storage of energy in advanced battery products, new building materials and the creation of new energy sources, such as clean coal, solar, biofuels and thermal power. Clean technology is being developed and implemented by multinational corporations, universities, government institutions, emerging growth companies, venture investors and entrepreneurs. The rapidly growing legal needs of this diverse industry have created opportunities for law firms and legal practitioners to assist in the formation, financing, growth and regulatory compliance of the companies that are deploying clean technology and to impact the development of the policies being created to foster and drive this growth. In addition, the provision of legal services to clean technology companies represents a growing revenue opportunity in an environment in which most practitioners and legal firms are experiencing a significant decrease in demand for their services.

As in technology cycles of the past, Silicon Valley is a leader in producing emerging growth clean technology companies. Many of these early stage companies are developing or supplementing technologies that were created in university

laboratories. Law firms and legal practitioners with experience negotiating with universities and that have relationships with the licensing groups within these universities are critically important in establishing successful, long-term partnerships. Critical to this success is an understanding of royalty structures and rates and appropriate allocation of the ongoing costs associated with technology development. Although almost all universities have a mandate to commercialize the research that their faculty creates, having an experienced adviser to lead companies to a win-win agreement can make the difference between a fundable, commercially viable company and one that fails.

Unlike the last cycle of technology companies, which focused on, among other sectors, the Internet, digital media, telecommunications and life sciences companies, “clean technology” has been around for decades and in some cases a century or more. Picture the entrepreneur or inventor who created an industry-changing technology in the ‘80s, the end of the last energy technology cycle. This entrepreneur has spent the last 20 years attempting to find funding sources for or other partners to develop his technology. In the instances where companies are formed to develop this “new” technology, lawyers need to have the skills to trace and track the development of this technology over an extended period of time and potentially to extract this technology from past transactions that limit or prohibit the ability of these technologies to be funded. Experienced licensing lawyers are necessary and critical to facilitate and consummate these transactions.

Patent portfolios play a vital role in many technology companies, and clean technology companies are no different. In addition, many of the technologies that are being developed or funded today are second- or third-generation technologies. The ability to obtain patent protection for these technologies and improvements to existing technologies require patent attorneys with deep domain expertise in chemistry, biology and engineering and the



ability to craft patent strategies that take into account the deep pockets of existing patent holders, including existing oil and gas companies. In many cases, clean technologies combine aspects of science from multiple disciplines that require patent lawyers with the ability to adapt to radically new processes and products.

After the formation and initial development of these technologies, clean technology companies need to finance further development and growth. Finance is an area where lawyers have played and will continue to play a critical role. Early stage clean technology companies have initially followed the traditional venture capital finance model, staged rounds of financing with a new lead investor negotiating an increased valuation for subsequent rounds. This model has and will continue to serve companies that are focused on energy efficiency solutions and other less capital-intensive industries.

But the economics of the venture capital model, which require large multiple returns on investment, place restrictions on the abil-

ity of venture capital firms alone to fund some clean technology companies. Certain clean technology industries, including biofuels, geothermal and solar, are incredibly capital intensive, with demonstration plants requiring \$50 million to \$100 million of capital and full-scale commercial plants requiring a factor of four or five times that initial investment amount. In addition, the current economic environment, the severe market corrections of the last two quarters and the decimation of the credit markets, have dramatically impacted private company valuations and their ability to raise equity.

A few notable companies were fortunate enough to raise large rounds of equity financing before the economic downturn struck. In those cases, traditional venture capital firms partnered with hedge funds, private equity firms and strategic investors to raise the large amounts of capital, at exceedingly high valuations, required by these companies. The capital structure created as a result of these investments will be challenged as these companies are required to seek additional rounds of financing in

a tough economic environment. Many venture capital firms will lack the capital to preserve their investments in these companies and most investors that do have capital to invest will seek to penalize non-participating investors. Companies will need seasoned finance lawyers who understand the complexities and competing interests involved with “down rounds,” recapitalizations and wash-out financings and the divergent interests of various company stakeholders. In addition, in the current finance environment, company lawyers must understand the corporate governance implications and pitfalls associated with insider lead financing rounds.

Many capital-intensive clean technology companies planned on project finance and capital market transactions to fund the build out of their facilities. Project finance teams, which historically operated in the oil and gas and other large-scale, project-driven industries, were, for the first time, an important part of the emerging company lifecycle. Prior to the start of the economic downturn, project finance lawyers have been instrumental in helping companies fill the financing gap between the end of the traditional venture capital model and profitability. But the state of the credit markets has virtually eliminated this funding alternative. Projections for the capital markets are equally dire. While it is clear that seasoned project finance and capital market lawyers will play an important role in the future of clean technology finance, especially given the likely case that such funding source will be more demanding and regulated than in the past, only time will tell if that role will be meaningful in 2009, 2010 or beyond.

The current financing landscape provides very few options for capital-intensive clean technology projects. Enter government finance. Recently, the U.S. Department of Energy, the U.S. Department of Agriculture and the 2008 Farm Bill have been instrumental in subsidizing emerging clean technology sectors, including solar, wind and biofuels such as cellulosic ethanol. In addition, individual states, in-

cluding California, have adopted innovative measures to encourage and fund clean technology development. Although novel and in many cases effective, these measures have provided a limited pool of capital and tax incentives to a subset of the clean technology industry. Access to much of the capital provided by these institutions and policies requires a time-consuming application and government selection process. Again, lawyers with experience in government grant writing and the negotiation of loan guarantees are critical in the efforts of applicants to obtain these funds. Increasingly, clean technology companies are relying on lawyers, both internally and externally, with federal and state government experience to supplement their finance capabilities.

The American Recovery and Reinvestment Act, commonly known to most people as the stimulus bill, attempts to take the next step in bridging the clean technology funding gap by allocating additional funds to existing Department of Energy and Department of Agriculture programs and by funding the conversion of government buildings to more energy-efficient facilities. Many of these policies are not yet formalized. Some might argue that clean technology companies now have lawyers in Washington deciding which and how privately funded technologies will survive. Whether that is true, lawyers and law firms will now play a direct role in influencing the development of the clean technology industry by creating and then implementing the policies that will fund many clean technology companies for the foreseeable future. Lawyers and law firms that have the ability to influence these policies and enable companies to benefit from them may be the most important advisers these companies will have.

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