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Grant R. Trigger, Chairperson Honigman, Miller, LLC 6600 Woodward Avenue, Ste.2290 Detroit, Michigan 48226 (616) 575-5655	Robert L. Schroder, Editor Robert L. Schroder, PLLC 8921 Margo Drive Brighton, Michigan 48114 (810) 229-0326	Peter D. Holmes, Assistant Editor BorgWarner Inc. 3850 Hamlin Road Auburn Hills, Michigan 48326 (248) 754-0889

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DUE DILIGENCE ISSUES FOR ENVIRONMENTAL COUNSEL: ACQUISITIONS AFTER SARBANES-OXLEY

Mark R. High*

Introduction

In this post-Enron world, it seems that disclosure has become the primary product manufactured by public companies in this country. Certainly, corporate management has recently spent a great deal of energy trying to understand and comply with new and existing disclosure requirements. Although there appears to be some movement afoot to scale back some of the Sarbanes-Oxley Act's¹ more onerous requirements, it is clear that the emphasis on corporate candor is not going away any time soon.²

Accountants are now required to review their clients' disclosure procedures, and determine whether both the procedures and the disclosure itself are adequate. On the environmental front, the Environmental Protection Agency recently introduced the ECHO project³ and advised the Securities and Exchange Commission (the "SEC") to pay more attention to environmental issues. At the same time, the Government Accountability Office has recommended to the SEC that environmental issues need to be more completely disclosed.⁴

Taken together, these developments mean that companies at all levels are more regularly monitoring environmental issues than in even the recent past. Companies are generating reports and sharing information regarding their environmental concerns with the people involved in the public reporting process, both inside and outside the company.

At the same time, merger and acquisition activity is on the rise again, approaching levels not seen in several years. Many, if not most, acquisitions involve taking control of land and buildings, either acquired through outright purchases of assets or assumed as part of the assets included in the acquired company. More reports and more information mean that there are more sources from which an acquiring company can obtain information regarding the target company's environmental status. Even run-of-the-mill property transfers will be affected by these new procedures.

Public and Private Companies?

These are not just the concerns of large publicly traded corporations; privately held companies can also be subject to Sarbanes-Oxley ("SOX").⁵ Lenders and customers can each require a company to adopt SOX-style procedures. A company's accountants and D&O insurance carriers can also prompt a company to do so. Many companies will even want to voluntarily comply with at least some of the SOX requirements. If a company anticipates going through an initial public offering, it may want to begin putting proper procedures in place to prepare for the big event. Similarly, a company which may want to put itself on the market in the near future might decide

that it becomes a more attractive acquisition candidate if it has SOX-style procedures in place.

Introduction to Disclosure Requirements

A quick review of the relevant Federal laws and regulations may be in order. Most of these actually pre-date SOX, but the current disclosure climate has brought a new focus to these pre-existing requirements. There are three main sources for Federal corporate disclosure requirements: Regulation S-K, FASB No. 5, and SOX.

Regulation S-K. Regulation S-K⁶ acts as an instruction manual for public companies filing their annual, quarterly, and updating interim reports with the SEC. Environmental concerns are particularly implicated in three items of Regulation S-K.

Item 101 requires reporting companies to describe their businesses, and report on their capital expenditures. In particular, companies must disclose the anticipated costs of environmental compliance, both current and projected, and any material effects that these costs may have on their earnings and competitive position.

Item 103 requires companies to disclose any pending, non-routine legal proceedings to which they are a party. In particular, Item 103(5) calls for disclosure of all Federal, state, or local administrative or judicial proceedings for the purpose of protecting the environment if (1) the company's potential liability is material to the company's business or financial condition, (2) its potential liability exceeds ten percent of the company's assets, or (3) a governmental agency is a party to the proceeding and the company's probable liability could exceed \$100,000. In the later case, a situation where a company is cited for some rather minor violation which nominally carries a fine of \$10,000 per day can very quickly escalate to where it needs, by law, to be included in the company's SEC filings. Environmental counsel might have at one time considered a situation like this to be routine and not worthy of notifying senior management; now, it must be reported.

Also, Item 303 of Regulation S-K requires a company's management to discuss known trends, events, and uncertainties which could have a material effect on its business (the so-called Management Discussion & Analysis, or MD&A, report). Some commentators are suggesting that Item 303 requires a company to discuss, for example, the effect of global warming on its business. While that might still be considered a stretch, a company might want to discuss the uncertainties arising from the barrels just discovered underneath the plant that it acquired two months ago.

FASB No. 5. Statement of Financial Accounting Standards No. 5: Accounting for Contingencies, issued by the Financial Accounting Standards Board, deals with disclosing loss contingencies. Observing FASB No. 5 is part of complying with generally accepted accounting principles, and is a key element to the audit letter process that many of us are familiar with. It requires a company to establish a loss contingency in its financial statements if (1) available information indicates that it is probable that the company has suffered a loss, and (2) the amount of that loss can be reasonably estimated. Even if a loss is only possible, or the value of the loss suffered cannot be reasonably estimated, it must be described in a footnote to the company's financial statements.

Sarbanes-Oxley. While Regulation S-K and FASB No. 5 have been around for many years, the new provisions receiving all the publicity come out of the Sarbanes-Oxley Act, adopted in 2002. Most important for this article are Sections 302 and 404.

Section 302 of SOX requires the chief executive officer and the chief financial officer of a company to personally certify certain items about the annual or quarterly report being filed. In summary, they must certify that they have read the report, that the report fairly presents the company's financial condition and results of operations, that, to their knowledge, the report contains no untrue statements or omissions of material fact which would make the statements misleading, and that they are responsible for and have evaluated the company's disclosure controls and procedures, and internal controls over financial reporting.

Thus, a company's senior officers must learn about the company's environmental liabilities and satisfy themselves that the company's periodic reports meet SOX requirements. This personal responsibility is causing senior executives to demand more detailed information and future cost estimates from environmental managers. Under Section 906 of SOX, a senior officer can be subject to potential criminal liability if he or she falsely, knowingly, or willfully makes an inaccurate Section 302 certification.

Under Section 404, a company has to establish and maintain adequate internal control structures and processes to allow for accurate financial reporting. In the company's annual report, its senior executives need to assess and report on the effectiveness of these internal control structures and processes. Further, the company's auditors must provide an independent report on management's assessment.

Taken together, these measures can be seen to require reporting companies (and companies otherwise observing these requirements) to:

- (1) review and, if necessary, adopt new environmental liability assessment and reporting practices;
- (2) include environmental matters in their Item 303 MD&A;
- (3) disclose environmental enforcement actions in their periodic reports;
- (4) disclose and value contingent environmental liabilities in their financial statements;
- (5) implement and periodically evaluate internal controls and procedures relating to environmental issues;
- (6) perform the actions called for by their internal controls and procedures, including maintaining internal records, establishing milestones for regularly reviewing and evaluating known problem areas, searching out new problem areas, and providing reports up and down the management chain;
- (7) have all of the above reviewed, evaluated, and certified to by senior management; and
- (8) have all of the above formally reviewed and audited by their accountants.

Due Diligence Resources

Any company with an interest in acquiring real estate has to look at that list of information sources and be glad. Many companies are now generating information which is much greater in both quantity and quality than that available even just two years ago. Not only is the new disclosure regime causing companies to look more closely at their environmental situation, the requirements of SOX Sec. 404 have resulted in a paper trail consisting of reports, reviews, evaluations, assessments, and reassessments that have never been available. Savvy acquiring companies (and their lenders) will jump at the chance to learn about their targets' environmental issues from the inside. Savvy targets will keep in mind that even reports which are being generated for "internal" review may actually become available to outsiders.⁷

Acquirers need to pull out their real estate due diligence checklists and adapt them to the new informational reality. No longer will it be sufficient to just poke some holes in the dirt, check on the status of permits, and ask some general questions about environmental history. Acquiring companies need to:

- (1) expand their review of publicly available information to include the EPA ECHO list and periodic reports filed by the target with the SEC;
- (2) specifically inquire about their target's internal review processes and procedures;
- (3) review the target's internal environmental policies;
- (4) examine the internal committees charged with monitoring and assessing the target's environmental compliance, including getting a list of committee members and their functions;
- (5) ask for the target's internal emergency response procedures;
- (6) consider whether other internal procedures might touch on environmental issues (e.g., as part of the target's accounting and legal functions);
- (7) inquire about what is generally known as the Disclosure Controls Committee, a general oversight committee which may gather and evaluate information generated by the internal review structure, including getting a list of committee members and their functions;
- (8) obtain all minutes, reports, memoranda, and valuations generated by these internal procedures; and
- (9) review the work papers and reports generated by the target's auditors while assessing the company's internal controls.

Information gathered this way not only tells the buyer about the property itself; can also be used to better value the transaction, *i.e.*, help establish whether the purchase price is right. It can help value and allocate risks coming out of the transaction, making for a more accurate and meaningful indemnification provision. It can also serve as a check on disclosure provided by the seller in the transaction's base

purchase agreement, and perhaps even provide an indication regarding the company's overall management structure.

In a recent situation we were involved in, our client was purchasing one plant from a public company with several plants around the country. In reviewing the selling company's SEC filings, we noticed a pattern to the impact issues which the seller identified at some of its other facilities. Based on that review, we expanded the sample parameter list in our Phase II environmental review, and the seller was forced to admit this increased scope was reasonable in light of its prior experiences.

Compliance after the Closing

After acquiring a business or property, the acquiring company will have to include the new assets in its future reporting and integrate the new assets into its existing internal controls and procedures. If the acquisition is significant, or consists of a stand-alone business, the buyer may have to develop new internal controls and procedures to cover the new assets. Perhaps in a worst case, a case that may become increasingly common, the target has developed its own procedures which the buyer now has to evaluate and either adopt or discard and replace.

The SEC seems to have given acquiring companies some leeway to exclude the recently acquired business from management's report on the internal controls over financial reporting.⁸ Even in this situation, the buyer needs to identify the acquired business, disclose that it has left the acquired business out of its report, and indicate the significance of the acquired business. This exclusion cannot last for more than one year after the acquisition.

Despite the delay allowed in the SOX Sections 302 and 404 reporting on the company's internal controls, companies cannot delay reporting an acquisition's more substantive effects. Thus, an acquiring company must be prepared to discuss the acquisition's environmental effects by the time its next periodic report is due. Depending on the size of the acquisition, this may result in real reporting issues in discussing capital expenditures under Reg. S-K Item 101, legal proceedings under Item 103, and known trends and events under the Item 303 MD&A, not to mention the loss contingency evaluation required under FASB No. 5.

In this light, pre-acquisition due diligence must be considered as part of the post-acquisition reporting process. On a more practical basis, acquiring companies may want to look at the calendar when scheduling transaction closings, to gain a few more weeks to integrate the acquired entity and its potential problems into the buyer's financial reports.

Conclusion

This brave new world has brought significant change to the way environmental issues need to be handled. It has also presented environmental counsel, both in-house and outside counsel, with significant opportunities to demonstrate the importance of their functions to senior management.

On the internal compliance side, environmental counsel will be called upon to prepare internal controls and procedures which are both comprehensive and workable.

Once those procedures are in place, preparing detailed yet concise reports will help management provide the SOX Section 302 certifications. In evaluating the potential liabilities which may exist, environmental counsel can play a vital role in fostering communication among managers, engineers, and accountants to arrive at a proper reserve valuation. All of these functions must be performed on time, as missing an SEC filing deadline can be very damaging to a reporting company, and its management.

On the acquisition side, environmental counsel should make sure that due diligence checklists cover all the new information sources. When an acquisition comes along, they should get involved in the due diligence process at the outset, and stay involved. It is important to keep an eye on the reporting calendar, and anticipate post-closing reporting requirements while doing the pre-closing review.

Counsel for sellers, or potential sellers, should review (or establish) reporting processes and systems, and prepare (or monitor) the resulting reports as though they were the subject of a due diligence request. Certainly, a company with effective internal procedures and controls in place will be more valuable than one without controls.

Above all, environmental counsel should stay visible, available, and involved. Information is a product which becomes more valuable every day; environmental counsel have access to some of the most valuable information a company can have. Monitoring, organizing, and distributing that information is a critical function that, when done well, can materially benefit a company and all its constituents.

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¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 18 U.S.C.).

² *Reining in Sarbanes-Oxley?*, The Washington Post National Weekly Edition, Vol. 22, No. 12 (Jan. 10-16, 2005), p. 13.

³ EPA's Enforcement and Compliance History Online database, or ECHO, is an on-line summary of state and federal environmental permit, compliance and enforcement histories covering the past three years for the over 800,000 EPA companies regulated under EPA or EPA-delegated programs. The database is available on the EPA's website, <http://www.epa.gov/echo>.

⁴ United States Government Accountability Office, *Environmental Disclosure: SEC Should Explore Ways to Improve Tracking and Transparency of Information*, 1, GAO-04-808, July, 2004, available at <http://www.gao.gov/new.items/d04808.pdf>.

⁵ See Justin Klimko, *The Sarbanes-Oxley Act: Possible Impacts on Privately Held Companies*, 83 Mich. B.J. 36 (2004); Ben L. Pfefferle, III, *The Sarbanes-Oxley Act: Implications for Environmental Management*, Baker & Hostetler LLP Executive Alert, Sept. 2004.

⁶ 17 C.F.R. Part 229, adopted under the Securities Act of 1933, 15 U.S.C. Sec. 77a *et seq.*, and the Securities Exchange Act of 1934, 15 U.S.C. Sec. 78a *et seq.*

⁷ A developing issue is whether attorney-client privilege can be used to keep certain internal review documents confidential. This issue is complicated by the fact that many of these internal reports are being disclosed to the outside auditors as part of their review of internal controls.

⁸ See SEC Office of the Chief Accountant, Division of Corporation Finance, *Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports, Frequently Asked Questions*, Question 3, available at <http://www.sec.gov/info/accountants/controlfaq0604.htm>.

The “Michigan Water Legacy Act” An Attempt at Filling in the Gaps in Michigan Water Law

By John Terzulli*

I. Introduction

The state of Michigan is at a crossroads in water law. Legislators are grappling with the possibilities of environmental degradation, exportation, and over consumption of the state's greatest resource, the Great Lakes Water Basin. Unfortunately, the current common doctrines of riparian ownership and reasonable use are inadequate.¹ The Michigan Water Legacy Act, as named by Governor Granholm on January 20, 2004, represents Michigan's attempt at introducing a statutory water regulation system, something already in place in other Great Lakes states.² The Act appears to ameliorate most of the significant problems with the common law system, but it also has problems of its own. These problems will most likely bring opposition to the proposal, especially by large scale consumers. The Act has recently been referred to the Committee on Natural Resources and Environmental Affairs. However, even if the proposed act is not passed, Michigan will not be able to resist the trend and pressure to enact a statutory water regulation system.

II. Legal Background

The Michigan Water Legacy Act represents a change in water law from the traditional common law approach to a statutory approach. Historically, Michigan has followed the common law doctrine of riparian ownership for surface waters and the reasonable use rule for underground aquifers. Together these doctrines make up the American Rule.³

The doctrine of riparian ownership gives property owners, whose property follows a natural watercourse, such as a lake, stream, or river, the right of reasonable use over it.⁴ Reasonable use, as defined by Michigan courts, allows each riparian landowner to use the water for any lawful purpose, as long as the use does not violate the rights of other riparian owners or disrupt the natural flow of the watercourse.⁵

Generally, reasonableness is determined on a case-by-case basis.⁶ Also, reasonableness is determined by present conditions without forethought of future water needs.⁷ Thus, a riparian owner could use all the currently available water. However, his use of the water could become unreasonable in the future if other upstream riparians begin to use it.⁸

Groundwater law in Michigan is covered by a separate doctrine called the reasonable use rule.⁹ In the groundwater context, a land owner is permitted to use as much of the groundwater as he pleases, as long as the use is reasonably related to the natural uses of land above.¹⁰

III. An Outdated Common Law System

Although the doctrines of riparian rights and reasonable use have served states well for many years, the modern era has created situations that make continued application of the American rule unworkable. There are several major deficiencies with the doctrine. First, the doctrine over-emphasizes the rights of the individual over the public interest.¹¹ As it stands now a land owner may continue to pump groundwater, even if people nearby are adversely affected.¹² For example, if a riparian owner has been pumping groundwater at high rates to water crops on the land above, the use would be considered reasonable even if the adjacent landowners suffer from a depleted aquifer as a result. This problem arises because reasonable use is determined relative to the uses of other riparian owners and one cannot be sure exactly how a new or existing owner will choose to use the watercourse in the future.¹³

Another deficiency is the lack of an adequate means of providing for dispute resolution among landowners. Under the current common law system, all disputes among land owners are settled through the judicial system. This method is both time consuming and economically inefficient. The resulting delays can pose a major problem for businesses and communities that rely on the water for day-to-day activities.¹⁴

IV. Water Depletion Concerns

Another reason for changing the current system, in addition to the legal drawbacks, are recent environmental concerns.¹⁵ As proposed, the Michigan Water Legacy Act deals mainly with diversions, consumption, and the ecological impacts of both practices. A recent study conducted by the International Joint Commission, a body empowered by the Great Lakes states and Canadian government under the Boundary Waters Treaty of 1909, has addressed some of these concerns. The result of the study was a general prescription for the states to take a precautionary approach toward resource protection.¹⁶

After examining the issue of diversion of waters to more arid states, such as Arizona, the commission found it would be highly unlikely due to the exorbitant expense of pumping water long distances.¹⁷ However, the Commission cautioned that the possibility of a major diversion is not completely out of the question, especially considering a rising population in the west.¹⁸ There is cause for concern regarding diversion to growing areas just outside the basin because pumping water shorter distances costs less. Also, there is a greater possibility that existing infrastructure could feasibly be expanded shorter distances.¹⁹

Currently, the only market for exported water is for bottled water.²⁰ Water bottled in Michigan comes almost exclusively from underground aquifers. When aquifers are over-pumped, significant harm to the surrounding area can result, although, basin wide effects are minimal.²¹

While these issues are not of immediate concern, the commission has concluded that the waters of the Great Lakes are a non-renewable resource.²² The Great Lakes are a vast body of water, but the rate of return to the lakes by natural processes is less than 1% of what is removed.²³ In addition, the rate of consumption is expected to increase with increased population, however, the exact amount of that increase is uncertain.²⁴ The Commission stated,

“Given the uncertainties associated with future climate change, consumptive use and possible pressures for removals,a precautionary approach is appropriate.”²⁵

V. Michigan Water Legacy Act Framework

Comprehensive water regulation has been on the agenda in Michigan since the 1985, Great Lakes Charter.²⁶ As part of that document, each state in the Great Lakes region agreed to regulate large-scale water withdrawals. Nineteen years later, Michigan is the only Great Lakes state without such regulations.²⁷

As proposed, the Water Legacy Act is really an amendment to the “Natural Resources and Environmental Protection Act” of 1994.²⁸ The Act is to be implemented by the Department of Environmental Quality (DEQ), but expressly states that the Act will not preempt the authority of local units of government to regulate water withdrawals.²⁹ Therefore, withdrawals will be regulated on both the local and state levels. Furthermore, the Department will have the ability to modify, place conditions upon, or revoke water withdrawal permits.³⁰

Permits would be granted for 20 year durations and be transferable to new property owners at the discretion of the Department.³¹ The statute expressly states that permits do not convey property rights to the holder.³² The statutory criteria for permit approval include a demonstration that the planned withdrawal will not damage the water resource or public interest therein, reduce water quality or quantity, and that the user will implement measures to conserve the resource.³³

As proposed, the Act applies to water users based on the amount of water used and whether the user is an existing one or is proposing a new or modified withdrawal. Three basic parts of the act lay out to whom the permitting process will apply.

First, users who propose new or increased withdrawals must obtain a permit if the withdrawals average 2 million gallons per day in any 30 day period, or 100 million gallons in a year.³⁴ Here, the Act draws a line between new and existing users, placing the brunt of the conservation effort on newcomers because existing users are subject to the permit requirement only if they increase their withdrawals. Additionally, beginning in 2010, the level of withdrawal that triggers the permit requirement for new or increased withdrawals will be reduced from 2 million to 100,000 gallons per day.³⁵ This provision will seriously restricts new users.

Second, beginning January 1, 2009, existing users that withdraw in excess of 2 million gallons per day on a 30 day average, or 100 million gallons per year, will be required to submit a 5 year water management and conservation plan.³⁶ There are several criteria for a valid management and conservation plan. There must be a demonstration of the effects of withdrawal on other users and on the natural resources.³⁷ Also, there must be a description of water management and conservation practices currently in use. The plan must be “environmentally sound and economically feasible.” This means “any beneficial reduction in water loss, waste, or use accomplished bywater management practices or conservation measures.”³⁸ A cost benefit analysis is required in order to determine the economic feasibility of the plan.³⁹ The plan must describe other measures to conserve water that were tried but not used and why they were not used.⁴⁰ This section of the Act exempts existing users from the

process altogether until January 1, 2009, and only requires one to submit a management and conservation plan, not a permit application.⁴¹

Third, the DEQ may require water users that currently withdraw 100,000 gallons per day, averaged over a 30 day period, to acquire a permit. A permit will be required if the DEQ determines that the withdrawal is causing, or is likely to cause, an adverse impact on the waters, the environment of the Great Lakes Basin, public health, safety or welfare, or to the public trust.⁴² Here, the Act requires permits for existing sources, but at the discretion of the DEQ.

A. Benefits of the Proposed Act

As proposed, the Michigan Water Legacy Act appears to ameliorate some of the problems associated with the current common law system. Additionally, the Act is a positive movement toward a precautionary approach of water protection.

To begin, individual rights can no longer preempt the public interest because the Act places control over the resource in the hands of the state as trustee for the public.⁴³ The Act expressly provides that all applications must demonstrate that the proposed withdrawals will not impair the public interest or the public health and welfare.⁴⁴ The combination of this provision with 20 year permit durations and the authority of the Department to revoke, condition, or modify permits, means that individual interest will give way to public interest. For example, if in the future, clean, freshwater resources are needed to meet public demand, individuals may be required to cease pumping. Furthermore, the Act appears broad enough to allow reallocation in times of drought from low priority uses to higher priority uses, such as drinking water.

Next, the proposed Act represents an alternative to judicial resolution of water resource issues. Time and resources would be saved by preempting state court decisions and eliminating case specific rulings on reasonable use.⁴⁵ The Act accomplishes this by authorizing the DEQ to deny an application if the use would not be reasonable based on the statutory criteria. Furthermore, according to the proposed Act, the permit holder must be given notice and may be given an opportunity for a contested case hearing before a modification or revocation can take place.⁴⁶ The opportunity for a contested case hearing may also be given to anyone affected by the proposed modification, including adjacent landowners, who must be notified before any withdrawals take place.⁴⁷

Lastly, the Act provides resources an adequate margin of protection from diversion, overexploitation, and exportation. The Act provides this protection by requiring that proposed withdrawals not significantly diminish or destroy the waters.⁴⁸ Thus, it would be very difficult for a new, or modified user, to export water, either through bottling or diversion, because to do so would mean that water quantity would be reduced.

B. Possible Drawbacks to the Proposed Act

Although the Act as proposed appears to eliminate some major concerns, it contains problems in regards to over-regulation in some areas and under-regulation in others. The Act is unfair in who it regulates and appears to have some adverse effects on business enterprises

due to its inflexibility and high standards.

The Act is under-inclusive because it exempts existing users from regulation until 2009.⁴⁹ This poses a problem of fairness because the only reason for exempting existing users is that they have invested in an area based on their ability to rely on water access.⁵⁰ This is in contrast to exempting households and other small users based on the fact that cumulative consumption does not significantly harm the water supply. Thus, new users or those who planned to increase their use will either be at a disadvantage, or be discouraged from locating in Michigan.

The Act also over-regulates new users and existing users after 2009. New users are subject to strict requirements for permit granting. The requirement that water quantity not be reduced would be nearly impossible to fulfill for any enterprise hoping to ship water out of the basin because the water would not be returned to the system. Additionally, the requirement of no injury to the public interest is a daunting task due to the wide array of activities that could be included in the public interest.

Under the Act, the DEQ has the power to revoke, modify, and condition permits when necessary for the public welfare.⁵¹ Thus, every time the public welfare is involved, the user would have to cease pumping water if the DEQ thought it necessary. Furthermore, this section would apply to existing sources by way of section 32711 subsection 3, giving the DEQ authority to require a permit if current usage is causing or likely to cause damage to the water, the ecology, or human health or welfare.⁵² This puts businesses in a precarious situation because capital investments will be hard to come by if there is no guarantee that the business will have a reliable source of water from which to run their operations and thereby receive a recovery of their capital outlay.⁵³ Furthermore, the fact that permits last only 20 years is a major drawback for businesses with long term business plans. If permit renewal is not automatic, the uncertainty associated with a business dependent on water withdrawals would be a difficult obstacle to overcome, both from a capital investment perspective and an operational standpoint.⁵⁴

Additionally, the requirement of a management and conservation plan for existing sources has the potential to be costly. The plan requires an analysis of the effects on other users and an analysis of the plan's economic feasibility.⁵⁵ Thus, the process could require the hiring of geologists, hydrologists, and economists to conduct the cost benefit analysis, depending on the depth required by the DEQ. Not only will a business have to comply with these management and conservation plans, and possibly the permit requirements, but also with local water authority regulations. This is so because the Act expressly gives local units of government the ability to continue to regulate withdrawals.⁵⁶ The sum of these regulations is a scary thought for some businesses, which is precisely why the Act, as proposed, will face strong challenges to passage.⁵⁷

Some of these issues could be remedied by allowing the permits to be traded within each watershed, similar to the Clean Air Act permit trading system.⁵⁸ In that way, a market for surplus permits would develop that would more accurately reflect the true cost of water in relation to water demand, while allowing for a more efficient allocation of the resource. This type of system would also allow large scale users to obtain additional water when necessary, thus, allaying some of the fears associated with permit revocation, modification, and renewal

denials. In theory, if permits and consumption are confined to a particular watershed then the cumulative effect of permit trading should not be significant changes to the local water system.⁵⁹

VIII. The Dormant Commerce Clause Issue

The Act, as proposed, may conflict with federal law in certain situations because it deals with waters that cross state boundaries and impinges on the ability of enterprises to conduct certain business. In particular, the Dormant Commerce Clause is a constitutional restraint on state power because the federal government has plenary power over interstate commerce, granted it by the constitution.⁶⁰

Under the Dormant Commerce Clause doctrine, federal courts may invalidate a state law that, on its face or by its effect, discriminates against out of state competition.⁶¹ In this case, the statute does not expressly discriminate against out-of-state industries. Any claim would most likely be analyzed as discriminatory only in effect, thus, requiring a showing of only minimal benefits to the local community in order to be upheld.⁶² The statute will most likely be upheld since there is a benefit to the local communities derived from the protection of their natural resource.

VIV. Conclusion

In conclusion, Michigan faces a dilemma. The state wishes to protect its greatest natural resource, but its current common law system is not up to the task.⁶³ The Michigan Water Legacy Act permit system is an attempt at remedying the problems associated with the current common law system, but the Act has its drawbacks. The Act appears to be both over-inclusive and under-inclusive at the same time, and the result may be challenges to its passage. However, sooner or later, Michigan will have to follow the lead of its fellow Great Lakes states and implement a statutory water regulation system.

**The article above was submitted by John Terzulli as an entry in the 2004 Environmental Law Essay contest. In accordance with ELS bylaws and policies, the Michigan Environmental Law Journal periodically publishes student articles which may be of interest to its readers.*

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1. Tarlock, *Water Resource Management* 2 (4th ed), p 515.
 2. Granholm, Michigan Water Legacy Act Proposal, 1 (2004).
 3. Ausness, Water Rights Legislation in the East: A Program For Reform, 24 Wm and Mary L R 547, 575 (1983).
 4. Michigan Law and Practice, vol 23, ch.3 Water and Water Courses sect. 56
 5. id.
 6. Three Lakes Ass'n v Kessler, 91Mich App 371; 285 NW2d 300 (1979)
 7. Prather v Hoberg, 27 Cal 208; 150 P2d 405 (1944)

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8. Hoxsie v Hoxsie, 38 Mich 77 (no number in original) (1878)
 9. Shenk v Ann Arbor, 196 Mich 75; 163 NW 109 (1917)
 10. id.
 11. Swenson, Public Trust and Groundwater Rights, 53 U Miami L R 363, 367-368 (1999).
 12. Harnsberger, Oeltjen & Fisher, Groundwater: From Windmills to Comprehensive Public Management, 52 Neb L R 179, 205 (1973).
 13. Lauer, Reflections on Riparianism, 35 MO L R 1, 10 (1970).
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 15. Granholm, Michigan Water Legacy Act Proposal, 1 (2004).
 16. Int'l Joint Comm'n, Protection of the Water of the Great Lakes: Final Report to the Government, 14 (2000), available at <http://www.ijc.org/boards/cde/finalreport/finalreport.html> [herein after IJC Final Report]<http://www.ijc.org/boards/cde/finalreport/final>
 17. id. at 41.
 18. id. at 13.
 19. id. at 15.
 20. id.
 21. id.
 22. id. at 40.
 23. id.
 24. id. at 41.
 25. id. at 18.
 26. Hoogterp, Legislators Announce First-Ever Water Diversion Bills, pg2 (2004), available at <http://www.boothnewspapers.com>.
 27. id.
 28. SB 1087 p1.
 29. id. at 9, at 21.
 30. id. at 22.
 31. id. at 21, at 24.
 32. id. at 25.

33. id. at 21.
34. id. at 16.
35. id. at 16.
36. id. at 9.
37. id.
38. id. at 2.
39. id.
40. id.
41. id. at 9.
42. id. at 16.
43. id. at 7.
44. id. at 22.
45. Lauer, n 11 supra.
46. SB 1087 p 22.
47. id. at 17.
48. id. at 21.
49. id. at 9.
50. Ausness n2 supra. at 575.
51. id.
52. id. at 15.
53. Ausness, n 49 supra. at 584.
54. id.
55. SB 1087 at 9.
56. id. at 25
57. Hoogterp n 26 supra. at 2.
58. Ausness, n 49 supra. at 587.

59. id.

60. US Const art I, § 8, cl3

61. Sullivan & Gunther, Constitutional Law (14th ed), ch 5, p 252.

62. id.

63. Tarlock n 1 supra.

COMMITTEE REPORTS

PROGRAM COMMITTEE

Meeting Minutes – July 21, 2005

The meeting was called to order on July 21, 2005 at 5:30 pm. The Attendees were Susan Topp, Matt Eugster, Jim O'Brian, Grant Trigger, Kurt Brauer, and John Tatum.

A. Planning Programs for 2005.

1. Higgins Lake Summary

- a. Cost was \$1,927.50 with 27 attendees.
- b. For future programs, it was suggested that we hold a few programs at the law schools.

2. Annual Meeting is September 22, 2005

a. Water Update

Topics will include Annex 2001, Nestle Case, Moratorium, Water Legacy Act

Speakers to include Patty Burkholz and Skip Pruss

Ken Gold contacted for assistance.

b. Hot Topics

c. Time will be 2:00 to 5:00pm

3. Fall Program.

- a. Air Update to be held at end of October.
- b. S. Lee Johnson will be contacted for assistance.
- c. Possible location is Lansing or Marion Oaks in Howell.

4. Winter Program in February.

- a. Environmental Law Boot Camp
- b. Joe Quant will be contacted on this issue.
- c. Topp is insisting that the program be held at Crystal Mountain to allow for family fun.

B. Next Meeting. The next meeting is Thursday, August 18, 2005 at 5:30 PM.

Meeting Minutes – August 18, 2005

The meeting was called to order on August 18, 2005 at 5:30 p.m. Attendees were Susan Topp, Michael Caldwell, Ken Gold, Kurt Kissling, John Byl, Grant Trigger, Matt Eugster, Joe Quandt, Anna Maiuri and Jim O'Brien.

A. Planning Programs for 2005.

1. **Annual Program.** The Annual Program will be on September 22nd, 2005 at the Kellogg Center. The topics and speakers for the program on September 22nd are as follows:

2:00 pm	Jon Allan	Annex 2001
2:45 pm	Patty Birkholz	Water Legacy Act
3:15 pm	Frank Ruswick	Wisconsin Governor's Directive Prohibiting Water Diversion from the Great Lakes Basin and DEQ New Rules to Regulate Groundwater Withdrawals
1:40 pm	Bill Rustem	Nestle Case
4:00 pm	Open Discussion	
4:30 pm	Business Meeting	
5:00 pm	Adjourned	

2. **Fall Program.** Discussion about the Fall Program reached a consensus that we should have a half day program on air. S. Lee Johnson will coordinate the air program. The other half of the program may include the following topics:
 - a. Criminal Investigation Unit, MDEQ, Chief Milton Scales
 - b. Investigations by the Attorney General's Office, Tom Piotrowski, Asst. Attorney General;
 - c. Brownfield Updates;
 - d. Refined Petroleum Fund Advisory Board - Speaker from Warner, Norcross & Judd
 - e. Part 201 Committee
 - f. Environmental Reporting under Sarbanes Oxley – Joe Berlin
3. **Winter Program:** The Winter Program will be the "Environmental Boot Camp. The focus of the program will be to educate young attorneys in the

area of environmental law. Joe Quandt will be coordinating that program. Discussions to hold the program in northern Michigan on a Friday to accommodate family ski weekend. Joe Quandt suggested Boyne Mountain due to the addition of their new water park. Susan Topp volunteered to obtain some other proposals from other ski resorts in the area and will follow up with Joe Quandt.

- B. Meeting Adjourned.** The meeting was adjourned at 6:05 p.m.
- C. Next Meeting.** The next meeting will be held on Thursday, September 15, at 5:30 p.m.

Meeting Minutes – September 15, 2005

The meeting was called to order at 5:30 p.m. Attendees were Susan Topp, Kurt Kissling, John Byl, Jim O'Brien, John Tatum, Robert Schroder, Matt Euchster

A. Planning Programs for 2005.

1. **Annual Program.** The Annual Program will be on September 22, 2005 at the Kellogg Center from 2 to 5 p.m. Topp to check with Ken Gold to make sure audio video arrangements have been made.
2. **Fall Program - November 9, 2005 at the State Bar Building in Lansing.**

8:30am. - 9:30 registration

9:30 - 4:30 program. Lunch included. Cost \$35 - 75.

Byl to check on State Bar Building costs. Half day program on air. S. Lee Johnson will coordinate the air program. The other half of the program will be the following:

 - a. Criminal Investigation Unit, MDEQ, Chief Milton Scales
 - b. Tom Piotrowski, Asst. Attorney General; program on criminal enforcement issues. He will talk for 30 min or so on criminal cases and how cases are referred, what factors make a case a felony versus misdemeanor, what divisions refer more cases, how cases work their way through the system.
 - c. Brownfield Updates - Grant Trigger/John Byl
 - d. Refined Petroleum Fund Advisory Board -Ken Vermeulen, Warner, Norcross & Judd
 - e. Part 201 Advisory Committee - Lynell Marloff??

- f. Environmental Reporting under Sarbanes Oxley - Joe Berlin or Mark High, Dickinson
 - 3. **Winter Program:** The Winter Program - "Environmental Law Boot Camp. The focus of the program will be to educate young attorneys in the area of environmental law. Joe Quandt will be coordinating that program. Northern Michigan ski location. Proposals are being collected by Topp. Joe will give a full report of topics and proposed speakers at the next program meeting.
- B. Meeting Adjourned:** The meeting was adjourned at 6:00 p.m.
- C. Next Meeting:** The next meeting will be held on Thursday, October 19, 2005 at 5:30 p.m.

Meeting Minutes – October 19, 2005

The meeting was held on October 19, 2005. Attendees were John Tatum, John Byl, Kurt Kissling, Kurt Brauer, Susan Topp, Matt Eugster, Anna Maiuri, Jim O'Brien and Michael Caldwell.

A. Programs.

- 1. November 10, 2005 Fall Program. Plans for the Program were finalized. John Byl and Kurt Kissling to check on powerpoint projector and powerpoint presentations by speakers. All speakers requested to email their powerpoint presentations to Kurt Kissling and bring paper copies for distribution to the attendees.
- 2. Winter Program. The Winter Program is the Environmental Law Boot Camp. Susan Topp reported that she still does not have any communication from Joe Quandt concerning the Environmental Law Boot Camp. Anna Maiuri reported that she participated in a telephone conference with Joe wherein the proposed agenda was discussed. Susan Topp to contact Joe Quandt to ascertain the status of the Program. The location of the Program is still planned to be at a northern Michigan ski resort.

- B. Next Meeting:** The next meeting will be held on November 22, 2005 at 5:30 PM.

MICHIGAN ENVIRONMENTAL CASENOTES

National Solid Wastes Management Association v. Granholm 344 F Supp 2d 559 (E D Mich 2004)

The court denied Plaintiff National Solid Waste Management Association's (NSWMA) request for a preliminary injunction preventing the implementation of the Solid Waste Control Package, a set of eleven Michigan laws that impose new limitations on the composition of solid waste eligible for disposal in licensed Michigan landfills. The laws became effective on March 26, 2004, and Plaintiff filed a complaint on April 5, 2005, challenging the constitutionality of three of the eleven laws. NSWMA contended that the package creates an unlawful distinction between in-state waste, which automatically qualifies for disposal in Michigan, and out-of-state waste, which does not. Out of state waste includes waste from other states within the U.S. and waste from Canada. If Plaintiff were correct, the laws would violate the "dormant" domestic and foreign Commerce Clause (which prohibits states from advancing their own commercial interests by curtailing the movement of commerce), and the Foreign Affairs Power. Defendants argued that the package contains neutral waste disposal regulations that treat in-state and out-of-state waste equally.

In evaluating the preliminary injunction request, the court concluded that plaintiff did not demonstrate a likelihood of success on the merits. It was not persuaded that the laws were enacted with a discriminatory purpose. The limitations on solid waste disposal appear to be facially neutral as they apply equally to solid waste originating in Michigan and outside of Michigan. The court could not say based on the record before it whether the laws have a discriminatory effect, because at the time of the filing of the complaint and motion for the preliminary injunction, the Michigan Department of Environmental Quality had not yet established any procedures for implementation and enforcement. The court viewed the laws as reasonable ways to keep ineligible solid waste from being disposed of in a Michigan landfill and denied issuance of a preliminary injunction.

Author: Tammy Helminski, University of Michigan Law School

Preserve the Dunes, Inc v Michigan Department of Environmental Quality 471 Mich 508; 684 NW2d 847 (2004)

TechniSand bought a sand mining operation in 1991. The adjacent land had been designated a "critical dune" area and thus closed to mining except under two limited circumstances defined in the Sand Dune Mining Act (SDMA), MCL 324.63702. In 1994, TechniSand applied for an amended permit to mine in the adjacent critical dune area under one of the §63702 exceptions, but the application was denied because TechniSand did not meet the statutory criterion of owning the land before July 5, 1989. In 1996, TechniSand resubmitted the application, received a permit, and began mining. After 19 months, Preserve the Dunes (PTD) brought suit under the Michigan Environmental Protection Act (MEPA), MCL 324.1701 *et seq.*, alleging that issuance of

the permit and the mining activity violated MEPA. The circuit court ruled for the Michigan Department of Environmental Quality (MDEQ), concluding that PTD's claim under SDMA was time barred and also finding that the mining would not lead to impairment or destruction of natural resources within the meaning of MEPA. The Court of Appeals reversed, determining both that MEPA allowed the MDEQ's decision to grant a permit to be challenged at any time and that TechniSand was ineligible for a permit.

A narrow majority of the Michigan Supreme Court held that MEPA does not authorize a collateral challenge to the MDEQ's decision to grant a permit under SDMA if the challenge does not relate to whether the permit holder's conduct would harm natural resources. The majority also determined that the permit challenge was time barred. The case was remanded to the Court of Appeals for review of the circuit court's findings on whether TechniSand's sand mining activity violated MEPA.

The majority emphasized that MEPA focuses on whether the defendant's actual conduct will pollute, impair, or destroy a natural resource. Under their reasoning, MEPA does not create a basis for judicial review of permitting decisions under SDMA because those decisions do not harm the environment on their own and do not depend on whether the defendant's conduct will harm the environment. In contrast, the dissent argued that MEPA should apply because issuing a permit to an ineligible operator under these circumstances would allow conduct likely to pollute, impair, or destroy natural resources.

Author: Melina Williams, University of Michigan Law School

United States v. Rapanos 376 F3d 629 (CA6 2004)

At issue in this case are three wetland sites that John Rapanos filled in violation of U.S. Environmental Protection Agency (EPA) compliance orders. The State told Mr. Rapanos that he would probably need a permit to fill the first site, the Salzburg site, due to the likely presence of wetlands. Mr. Rapanos had the site inspected by Dr. Goff, who reported there were between 48 and 58 acres of wetlands on the site. Mr. Rapanos threatened Dr. Goff, telling him to destroy his report and map of the wetlands. Dr. Goff refused and Mr. Rapanos decided to destroy the report and bulldoze the site himself. In April 1989, Mr. Rapanos had workers clear the land, fill in low spots, and cover the wetlands with sand. In August 1989, Mr. Rapanos denied the State permission to inspect the site, forcing the State to use a search warrant three months later. In 1991, a state inspector noted the site had been "tiled" to drain subsurface water. Mr. Rapanos refused to comply with an EPA administrative compliance order to stop filling the wetlands. Mr. Rapanos continued to fill the Hines Road and Pine River sites in defiance of state cease and desist orders. The EPA issued administrative compliance orders for both sites and alleged that Mr. Rapanos failed to comply with them.

The United States filed civil and criminal actions against Mr. Rapanos, adding his wife and Prodo, Inc. (a company he owned) in the civil case. The district court determined that the Clean Water Act (CWA) had jurisdiction over the filled wetlands because they contained a hydrological connection to tributaries of navigable waters, giving them a "significant nexus" to navigable waters as required by precedent. The

defendants appealed the ruling, arguing that there was no “significant nexus” connecting them to navigable waters and thus no jurisdiction. The appellate court rejected the government’s argument that the defendants waived a defense of a “direct abutment” requirement to CWA jurisdiction. Even though the defendants only argued “isolated waters” at trial, the appellate court saw this issue as “splitting hairs,” as the argument involved a question of law and factual record fully developed in the court below. Sixth Circuit precedent had already determined that no “direct abutment” is required for CWA jurisdiction; rather, a hydrological connection or other “significant nexus” between non-navigable and navigable waters is sufficient. The district court found that all three sites were hydrologically connected to tributaries adjacent to navigable waters and the defendants were unable to prove that the district court’s findings were clearly erroneous. The appellate court found the district court’s decision to use the testimony of the plaintiff’s expert, Dr. Willard, about the wetlands an appropriate use of discretion. The court also found that the delegation of authority to Michigan to implement the CWA permit program did not limit the scope of CWA jurisdiction. The sites fell within the federal regulatory powers of the CWA, whether or not they were covered by the Michigan permit program. The appellate court affirmed the district court ruling.

Author: Miranda Welbourne, University of Michigan Law School

ENVIRONMENTAL LAW SECTION COUNCIL MEETINGS

MEETING MINUTES – September 22, 2005

Present:

In Person: Peter Holmes, Anna Maiuri, Bob Schroeder, Susan Topp, Grant Trigger, John Tatum, Chris Bzdok, Chris Dunsky, Susan Johnson, Tom Phillips, Charlie Denton, Tim Lozen, Richard Barron.

Absent: Todd Dickinson, Beth Gotthelf, Steve Huff, Craig Hupp, Mike Leffler, Sharon Newlon, Dustin Ordway, Pat Paruch, Joe Quandt, Mike Robinson, Charles Toy, Tom Wilczak.

1. **Minutes:** The minutes of the June 18, 2005 meeting were deferred to the November meeting.
2. **Secretary-Treasurer’s Report:** None.
3. **Standing Committee Reports:**
 - A. **Membership.** Chris Bzdok reported on the attempts to get more young lawyers into the Section. Recommended having more interactive programs. This topic will be discussed further at the November Council

Meeting. Peter Holmes also recommended having more of the meetings at law schools.

- B. **Program Committee.** No report.
- C. **Michigan Environmental Law Journal.** No report.

Stuart Freeman Essay Contest. Bob Schroder reported that Tammy Huminski was awarded \$2,000 for her essay. Her topic was on construction permits for privately owned treatment plants. Tammy is a student at University of Michigan Law School. The next environmental law essay contest due date is June 30, 2006.

- D. **Nominating Committee.** Report by Grant Trigger. The nominating committee was comprised of John Byl, Peter Holmes and John Tatum. Ken Burgess has resigned from the Council due to relocating to Colorado. The Nominating Committee recommended Peter Holmes for Council Chair, John Byl as Council chair Elect, and Susan Topp as Secretary/Treasurer. New Council members recommended were Ken Gold, Dennis Donahue, Kurt Brauer and Michael Caldwell (to complete the term of Ken Burgess. Motion by Richard Barron to approve recommendations of the Nominating Committee, second by Tim Lozen.

4. **Subject Matter Committee Reports.**

- A. **Air.** None.
- B. **Environmental Litigation.** None.
- C. **Hazardous Substances and Brownfields.** None.

5. **Liaison Reports.** None.

6. **Chairperson's Report.** Grant Trigger passed the gavel to Peter Holmes. Peter Holmes made a short statement presenting his goals for the ELS for the coming year. The goals included achieving involvement in the section by more young attorneys and to reinvigorate the Section's committees.

7. **Vice-Chairperson's Report.** None.

8. **New Business.** None.

9. **Annual Meeting.** None.

10. **Meeting Adjourned.** Motion to adjourn by Grant Trigger, second by Chris Bzdok.