

Don't Undercut Timberland Purchase And Sale Agreements

Law360, New York (November 13, 2012, 2:00 PM ET) -- Interest in timberlands investment continues to grow. Those actively acquiring and selling timberlands, including timber investment management organizations, real estate investment trusts, forestry companies, and other investors and owners, are drawn to timberlands investment for a variety of reasons, including potential long-term growth, diversification, inflation hedging, reasonable liquidity and relatively modest volatility.

In addition, timber as an asset class is unique in that trees continue to grow in size (and hopefully in value) with the passage of time, therefore affording the timberlands' owner flexibility as to when to cash in on the investment. For example, a savvy timberlands owner will leave the timber standing when prices are low and then deliver cut timber to the market when prices are more favorable.

In many respects, the fundamental components of a purchase and sale agreement for timberlands are similar to other types of commercial real estate. However, because timberlands are unique compared to other commercial real estate assets, a number of issues arise in a timberlands deal that do not apply to other types of real estate assets.

Similarly, a number of provisions of a timberlands purchase and sale agreement should be handled differently than in a traditional commercial real estate purchase and sale agreement. Although an exhaustive analysis of all of these distinctions is beyond the scope of this article, a few key distinctions are discussed below.

Harvest Adjustments

The issue of whether to include an appropriate mechanism to adjust the purchase price on account of harvested timber is unique to a timberlands purchase and sale agreement.

A timberlands seller may be harvesting timber pursuant to a harvest plan (usually an annual plan). Harvesting of timber on the timberlands to be conveyed may continue after contract signing through the closing date, either by the seller or pursuant to cutting contracts that the seller may have entered into with its affiliates or third parties; this, of course, impacts the value of the timberlands on the closing date.

A buyer would be well advised to carefully review the terms of any such cutting contracts to understand their impact on the acquired timberlands. External factors, including market capacity, destruction of the timberlands, timber crop pricing and the weather may influence the amount and type of timber that is harvested and the necessary adjustment on the date of closing.

The preferred purchase price adjustment mechanism depends on the nature and complexity of the transaction. Some adjustment mechanisms delineate in great detail the type of timber to be harvested and establish an adjustment amount that varies based on that type of timber. Others take into account the specific location or region where the harvesting occurs. Some adjustments tie to the actual receipts generated from the timber harvesting while others adjust relative to a baseline estimated harvest value. Some include a combination of these mechanisms.

Furthermore, the parties should also determine when to calculate the final harvest adjustment as the size of the timberlands and the scope of the timber harvesting operations may necessitate both a pre-closing adjustment and a subsequent post-closing adjustment.

Casualty Loss

It is important to consider how to address potential casualty loss in any commercial real estate purchase agreement. One major distinction, however, between timberlands and commercial buildings that impacts the sale documentation is that most commercial buildings are covered by casualty loss insurance, while timberlands generally are not.

Another important difference is the significantly greater risk of a casualty event occurring with respect to timberlands than with respect to a commercial building. In a timberlands deal, the parties should negotiate the consequences of a casualty event or natural disaster affecting the timberlands that occurs (or is discovered or disclosed) after the purchase and sale agreement is executed, but before the closing.

Common casualty events affecting timberlands include forest fires (whether man-made or caused by lightning strikes, especially in times of prolonged drought), hurricanes, windstorms, floods and earthquakes. Insect infestation, blight and disease can also damage standing timber and thereby materially decrease the asset's value.

Damage from a casualty to timberlands is not repaired or restored in the same manner as damage to a commercial building. If timberlands are damaged by casualty, the soil may need to be made suitable for future tree growth, and, in any case, trees will need to be replanted; it may take dozens of years before the replanted trees mature to a point where they can be economically harvested.

Also, when timber is damaged by casualty, the timberlands owner often seeks to recover the salvage value of the damaged timber by selling it to mills or other purchasers. If a casualty event is widespread in a region, the price being paid for such damaged timber might be depressed due to a glut of timber unexpectedly being sold in the market at the same time from similarly situated timberlands owners.

In the purchase and sale agreement, the parties should agree on the appropriate allocation of the risk of casualty loss. If the casualty is significant or exceeds certain thresholds (perhaps measured by acreage), the parties might consider a purchase price adjustment mechanism. The parties also need to decide whether casualty damage to timberlands infrastructure, such as bridges or roads, would result in any purchase price adjustment or whether the adjustment would only be based on damaged timber.

In transactions involving very large acres of timberlands, another challenge is determining (as of the closing date) whether a casualty has occurred; to address this timing issue, sometimes the parties agree on a short post-closing period for discovery of such losses and the making of any associated purchase price adjustments.

Title Issues

No different than any other commercial real estate transaction, a buyer should carefully review the title to the timberlands and obtain a title insurance policy at closing. Since timberlands deals often involve the conveyance of large tracts of land, title diligence can be more time-consuming and complex than a typical commercial property.

For example, the legal descriptions for the timberlands may be voluminous and may have emanated from even larger tracts that have been sold off in pieces over time, which makes the title review process more involved and complicated. In some cases, descriptions may be extremely vague, such as a boundary marker like “the old hanging tree.”

Since timberlands deals often involve thousands of acres of land, ALTA surveys for all of the acreage are, in general, prohibitively expensive and impractical. As an alternative to survey review, depending on the jurisdiction, diligence might include a review of tax maps, geographic information system (GIS) data and other available maps.

The lack of a survey will probably impact the availability of extended title insurance coverage for the buyer, although some alternative title insurance endorsements or coverages might be available depending on the circumstances. If a particular portion of the timberlands is valuable as so-called “HBU land” (i.e., land that might be suitable for a higher and better use than the growing of timber, such as perhaps future commercial development) or important for another reason, the buyer might consider obtaining a survey for this area.

Another title consideration is whether mineral rights have been severed from the timberlands or are being conveyed with the timberlands. A minerals search is a very expensive and time-consuming search that is separate and distinct from a typical land title search. If minerals have been severed, in most jurisdictions, the general rule of thumb is that the rights of the mineral owner will have primacy over those of the surface owner, so understanding applicable mineral laws, and how those laws impact use of the surface for growing and harvesting timber, is advisable.

The status of legal access to the timberlands is another important due diligence consideration. While most commercial buildings will abut a public way or have dedicated right-of-way or easement rights, some parcels of timberlands may be landlocked and, therefore, may only be accessed over land owned by third parties.

The buyer should evaluate whether it has valid easement rights to access and harvest the timberlands and the extent to which it has the right to use, construct and maintain access roads across the lands of others. In the absence of valid legal access rights, the timberlands buyer should evaluate whether there is sufficient verbal, historic or practical access to the timberlands. A key issue to discuss with the title insurer during the due diligence process is the extent to which the insurer is willing to provide access coverage in the title policy.

Common encumbrances affecting timberlands are conservation easements, forestry legislation, or other similar use programs or restrictions. Rights-of-way agreements also frequently encumber timberlands. Careful review of these encumbrances is necessary to understand the impact of, and restrictions created by, such documents on the harvesting of

timber and the rights others (such as the general public) might have in and to the timberlands. For most commercial properties, buyers are certainly familiar with the possessory rights of tenants of the building and the impact of such leasehold rights on the buyer's title.

As an additional revenue source, many timberlands owners lease or license their lands for hunting, camping or other recreational use. Some timberlands may be encumbered by grazing or farming leases. These leases or licenses are oftentimes off-record instruments and usually for a short-term (but with renewal features). If the acreage of timberlands involved is very large, there may be many such agreements. The title company will likely take an exception for the rights of such lessees or licensees in the owner's title policy.

Environmental Issues

As with any commercial real estate transaction, environmental matters (such as environmental due diligence; compliance with federal, state and local environmental laws and regulations; and allocation of responsibility for environmental issues) should be addressed in the timberlands purchase and sale agreement. Some environmental issues for timberlands transactions differ from those associated with most commercial properties.

One example is the process for conducting environmental diligence of timberlands. The ASTM standard practice for Phase I environmental site assessments for forest land of 120 acres or greater (ASTM Practice E 2247-08) differs from the ASTM standard practice applicable to commercial buildings. This specialized ASTM standard practice for forest lands takes into account the differing use and larger size of the timberlands. Where extremely large tracts of lands are involved, a complete physical site inspection of every portion of the timberlands would be impractical and cost-prohibitive.

Therefore, appropriate environmental diligence of timberlands will depend on a number of considerations, but might include aerial surveillance of properties and assessment of targeted areas. Environmental issues sometimes associated with timberlands are those that arise from activities such as mining on a site, improper use of pesticides and herbicides, and those associated with unauthorized dumping on the timberlands, which can range from minor household dumping to more serious disposal of hazardous substances.

Determining whether the timberlands are environmentally sensitive or culturally important, such as by reason of the habitation by endangered species or the existence of significant archeological sites, is also an important consideration.

Conclusion

The purchase and sale of timberlands has many similarities with other commercial real estate assets, but also many important unique considerations. Although important distinctions include the harvest adjustments, casualty, and title and environmental matters described above, a timberlands transaction has numerous other distinguishing and differing characteristics, including, among others, tax and financing considerations. Investors should seek counsel familiar with these distinguishing features to properly manage the legal risks that accompany timberlands purchase and sale transactions.

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