

Environmental Concerns in Real Estate Transactions

by Ann R. Barker
Baker Petrolite Corporation

Real Estate Transactions and Issues

Background

Since the early 1980s, federal and state legislation has been enacted that has made environmental liability issues a matter of significant concern in many commercial and industrial real estate transactions. During this time, the cost to clean up often presented multi-million dollar liabilities, and the legal theories used to collect on those liabilities involved multiple parties and years of legal and consulting fees, in addition to cleanup costs and possible penalties or fines. Because of the heavy potential liability costs, the demand for information about sites emerged in a number of ways and to some degree before standards of practice had been developed. Variations in practice and procedure to gain the desired information also fueled some of the real estate litigation during this period. Because various parties to a transaction, (i.e., purchasers, sellers, lenders, attorneys investors, real estate brokers, landlords, tenants), often had competing or unique interests, the need to develop a recognized and accepted standard of practice became obvious. The need for a more uniform and reliable standard of practice for environmental assessments was also driven by the various types of transactions (i.e., corporate acquisitions and divestitures, bankruptcy, estate management, and investment)(1).

Due Diligence

“Due Diligence” is the term used to describe the general process by which parties involved in a commercial or industrial real estate transaction obtain information on the environmental condition of the property and inform themselves on whether the property is environmentally sound or presents a risk of future liability. The scope of due diligence has varied greatly over the past twenty years. Even after the advent of recognized and accepted standards for conduct of due diligence, those standards vary depending upon the transaction type and/or level of known risk associated with the property (i.e., Transaction Screen, Phase I Environmental Assessment (ESA), and Phase II Site Assessment). These standards will be discussed in more detail below.

In general, due diligence incorporates some form of preliminary evaluation and/or Phase I ESA so that a purchaser or lender may quickly determine whether they have no further interest in the property because of high potential risk of liability. Today most transactions begin with a Phase I ESA because very few lenders will participate in a transaction without one. If a Phase I ESA shows evidence of “recognized environmental conditions”(2), the parties may move to the next step, a Phase II Site Investigation (SI), which will include intrusive site investigation (i.e., soil or groundwater sampling and testing). If the Phase II confirms that the site is contaminated then the parties may cancel the transaction, or proceed with negotiations to account for the environmental liabilities.

Due diligence is essential to allow prospective purchasers to reduce the probability that they may purchase contaminated property and be subject to expensive cleanup and to have the necessary evidence to satisfy the “*all appropriate inquiry*” standard. Satisfying this standard is necessary to qualify for the various defenses to liability available under federal Superfund and most state cleanup liability laws(3).

Site Assessment

Responsible parties to corporate transactions and real estate acquisitions, leasing of property, lending of money, creating of security interests, among other things, now require that some form of environmental audit or site assessment be conducted to identify and quantify environmental liabilities, to the extent possible. These steps are necessary to properly value the assets and determine whether to go forward with the transaction, and/or negotiate reasonable terms and conditions. A site assessment can establish an environmental baseline as protection against future cleanup costs or enforcement action. Sometimes lenders and lessors may negotiate to conduct assessments or audits periodically during the term of the loan or lease to ensure that on-going operations are not creating environmental liabilities(4).

Transaction Screen Process

The ASTM Transaction Screen Process is a general site assessment that typically includes the following (1) asking questions contained within the transaction screen questionnaire of owners and occupants of the property, (2) observing the site conditions of the property with direction from the questionnaire, and (3) conducting a limited research and review of governmental agency records, databases and standard historical sources. This process may be conducted by an environmental professional, purchaser, or lessee. The analysis is based on reasonable business judgment and the totality of the answers provided to the questionnaire and any unresolved or unknown issues. If questions in the questionnaire are answered in the affirmative or the answer is unknown, then additional information must be obtained or the rationale for determining that no further inquiry is warranted must be documented. If additional inquiry is warranted, then it may be limited to the open questions or proceed to a full ASTM Phase I ESA conducted by an environmental professional(5).

Phase I Environmental Site Assessment

In the early 1990s, the American Society for Testing and Materials (“ASTM”) organized a group with representatives from industry, real estate, banking, engineering, consulting, and environmental protection to work on better defining “the good commercial or customary practice.” The effort produced the E 1527-93: Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process. This standard was originally published and almost immediately accepted as the “due diligence” standard for commercial and industrial real estate transactions. The standard has been revised twice, with the last revision in 2000 and continues to be the standard for conduct of “all appropriate inquiry” until EPA publishes its final regulations(6). It is expected that ASTM will revise the standard to be in accord with the regulations following final promulgation.

A Phase I ESA includes four major elements:

- records review
- site reconnaissance
- interviews with owners or occupants and with government officials
- written report to the client.

The information must only be “reasonably ascertainable”, which is interpreted to mean that it must be:

- publicly available,
- obtainable from its source with reasonable time and cost constraints,
- practically reviewable.

Thus, difficulty in obtaining information and the time allocated to complete the work will frequently drive the amount of detail contained in the final report. Regardless, the level of effort must be sufficient to identify recognized environmental conditions and to determine whether contamination is likely(7).

Phase II Site Investigation

If the Transaction Screen or Phase I ESA identifies a recognized environmental condition, such as staining, the presence of underground storage tanks, or historical evidence of contamination on adjacent property, additional investigation is warranted. A Phase II Site Investigation (SI) is typically performed to gain sufficient information to determine the nature and extent of contamination, if any, to make an informed business decision about the property. The ASTM E 1903-97 (2002)(8) is generally accepted as “good commercial and customary practice” in this step in due diligence for real property transactions.

The parties to a transaction usually negotiate the level and extent of the investigations. Nevertheless, the typical Phase II SI has four main components:

- developing a scope of work,
- conducting assessment activities,
- evaluating and presenting the data, and
- presenting the finding and conclusions.

In some cases the SI may be conducted in stages, with each stage being more detailed and/or intrusive, with the option to cease if parties have obtained sufficient information to make an informed business decision concerning purchase, lease, or lending for the real property. The report should be clear, concise, unambiguous and legally defensible to support decisions concerning the property(9).

Environmental Liability

Purchasers of real estate acquire the property subject to applicable environmental regulations that restrict use of the land and subject the owner to liabilities imposed by applicable environmental programs. Generally, the regulatory authority will look to the owner of the property or the operator of enterprise that involves hazardous substances if issues of contamination surface. That is not to say that the parties to a real estate transaction may not find various contractual mechanisms to shift those responsibilities or liabilities(10), but the government will look first to the land owner. Both federal and state Superfund statutes create liability and withdraw protective defenses for owners and operators who know of hazardous substance contamination and fail to disclose that to purchasers(11).

Federal Laws

Pollution prevention programs and chemical regulatory programs may affect real property transactions because they frequently give rise to substantial liabilities for prior activities conducted in violation of the requirements. Liabilities associated with current or historical on-site conditions may arise out of the following federal programs and statutes:

- Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. §§ 9601-9675, commonly known as Superfund, was enacted in the 1980 to address the unregulated historic disposal of hazardous substances. The liability structure is set very wide to capture numerous parties, including the current owner, even if the owner was not involved in the disposal

of contaminants. CERCLA created the concept of strict, joint and several, and retroactive liability. Defenses to Superfund liability are discussed below.

- Resource Conservation and Recovery Act, enacted in 1976, was amended in 1984 to require cleanup of contamination from improper waste management practices that occurred at RCRA-permitted facilities, providing for corrective action for releases migrating beyond the property boundary and to abate imminent and substantial hazards caused by releases of solid or hazardous waste(12).
- Underground Storage Tank Program was an amendment to RCRA that regulates underground and above ground storage tanks containing petroleum or hazardous substances and provides a cleanup liability scheme(13).
- Toxic Substances Control Act establishes the programs for regulation of Polychlorinated biphenyls; (“PCBs”), asbestos, and lead paint abatement(14);
- Occupational Safety & Hazard Administration imposes requirements on building owners and operators relating to building demolition or renovation because of the presence of asbestos(15); and

State Laws

Many contaminated sites in the United States do not meet the strict requirements for listing under Superfund or fit into the RCRA corrective action program; however, these sites are frequently covered under state remedial action programs. There are a variety of state-specific remediation programs, but typically include the following:

- State “Mini-Superfund” Statutes – many states have cost recovery statutes similar to Superfund(16);
- Risk Reduction or Corrective Action Programs – programs of risk-based corrective action for remediation of releases of toxic and hazardous substances(17);
- Brownfields Redevelopment / Voluntary Cleanup Programs – incentives for clean up of contaminated land, and frequently provides liability defenses for voluntary state-law mandated cleanup(18); and
- Contaminated Land Transfer – liens authorized to secure cleanup costs incurred by regulatory agency(19).

Limited Liability Defenses

Federal Superfund provided certain limited defenses to its strict liability scheme: (1) the act of a third party, (2) act of god, or (3) act of war. The last two defenses were pretty unlikely to be invoked, and it was not particularly easy to succeed in claiming the Third Party Defense:

1. release was caused by third party;
2. owner did not have contractual relationship with third party;
3. owner took reasonable actions against the acts or omissions of the third party; and
4. owner exercised due care regarding hazardous substances at the property.

To reduce the harsh effects of the strict liability provisions of federal Superfund liability, the innocent owner defense was added as part of the first set of amendments to Superfund (Superfund Amendments and Reauthorization Act, “SARA”)(20). This defense allows that even with a contractual relationship the purchaser could gain innocent landowner status if after conducting a due diligence inquiry, he had no reason to know that any hazardous substances were disposed on the facility. This language became a primary driver for performance of due diligence to meet the “*all appropriate inquiry*” standard before completing a real estate transaction. Although the innocent owner defense provided some limited protection for those purchasers who,

after performing *all appropriate inquiry* did not detect contamination at the site, this defense did not solve problems of liability attaching at those sites with known contamination or where due diligence had not been adequate. Thus, environmental liability remained as a significant obstacle to development of existing commercial and industrial property with evidence of contamination.

CERCLA Amendments and “*all appropriate inquiry*”

The Brownfields Act(21), which became law in January 2002, modifies CERCLA to encourage development of properties that are contaminated or are perceived as contaminated(22) and to recognize liability exemptions for certain parties who might be liable for the cost of cleaning up site contamination at Superfund sites. The law recognized the previous “innocent landowner” defense and added two additional new defenses:

- bona fide prospective purchaser; and
- contiguous property owner.

The innocent landowner defense, as describe above, allows a purchaser of property to qualify for the third party defense notwithstanding a contractual relationship with the party responsible for the contamination, provided the person undertook *all appropriate inquiry* into the previous ownership and uses of the property consistent with good commercial or customary practice in an effort to reduce liability and did not know or have reason to know of the existence of hazardous substances.

To qualify as a bona fide prospective purchaser, a person must not be affiliated with the party responsible for the contamination and be able to establish the following:

- Disposal occurred prior to acquisition;
- Made *all appropriate inquiry* into the previous ownership and uses of the facility under good commercial and customary standards and practice;
- Provided all legally required notices;
- Exercised appropriate care with respect to hazardous substances to stop any continuing release and preventing future releases and human, environmental and natural damage exposures;
- Fully cooperated with party authorized to conduct response or natural resource restoration action;
- Complying with land use restriction and is not impeding institutional controls; and
- Responds to requests for information.

The Act also creates a landowner defense for persons who own real property that is contiguous to land that is or may be contaminated by hazardous substances by a release from real property not owned by that person; However, the owner must take reasonable steps to stop the release and observes the other continuing obligations that are set out below.

All Appropriate Inquiry (AAI) – Redefined

In the past, the “good commercial or customary practice” was sometimes open to debate, but generally regarded as contained in the ASTM Phase I ESA Standard. However, the Act now defines the standards for *all appropriate inquiry* and set a two-year deadline by which EPA must promulgate regulations for implementation of the standard, which must include the following:

- Inquiry conducted by an environmental professional;
- Interviews with past and present owners, operators, and occupants;
- Review of historical sources;
- Searches for recorded environmental cleanup liens;
- Review of governmental and other records

- Visual inspection of the facility and adjoining properties;
- Specialized knowledge or experience on the part of the defendant;
- Relationship of purchase price to value of property if property was not contaminated;
- Commonly known or reasonably ascertainable information about the property and
- Degree of obviousness of presence or likely presence of contamination of property, and ability to detect contamination by appropriate investigation(23).

The EPA published the new AAI definition and standards in August of 2004(24). The regulations were the product of a stakeholder rulemaking committee with many of the same commercial and industrial interests that were involved in development of the ASTM standard. The regulation has received so many comments that EPA is now estimating that the response to comments and final will rule will not be published until sometime in early 2006.

The new AAI regulations seem to require a more involved assessment than is currently conducted under ASTM. The AAI is more performance-based allowing discretion on the part of the environmental professional, as long as the investigation is successful in detecting any existing or threatened releases of hazardous substances. The new AAI seems to ratchet up the level of due diligence and is likely to have significant short-term effects on commercial / industrial real estate transactions. The breadth of investigation, time necessary for investigation, and cost of due diligence under the AAI standard are very likely to increase.

The following elements of the new AAI standard depart from the ASTM standard and broaden the scope of inquiry(25):

- Interviews – requires interviews with a wider range of individuals with knowledge of the property, including past and present owners and operators, employees of current and past occupants, current and past facility managers with relevant knowledge, and (if abandoned property) owners and operators of nearby property;
- Visual Inspection – requires a more comprehensive visual inspection of adjoining properties
- Review of Government Records – goes further than the ASTM required government databases, listing categories of federal and state records that must be reviewed (i.e., records of public risks & public health threats; registries of engineering controls, institutional controls, and land use restrictions, etc.);
- Data Gaps – requires a final report that acknowledges areas of uncertainty (data gaps) that impact conclusions;
- Environmental Cleanup Liens – requires search for environmental cleanup liens under federal, state, tribal, or local laws;
- Timing of AAI – requires that certain inquiries must be conducted six (6) months prior to the date of purchase of the property: interviews with past and present owners, searches of recorded liens, reviews of governmental records, visual inspections, and the environmental professional’s declaration (if a transaction is delayed, then certain elements may have to be updated); and
- Environmental Professional(26) - AAI must be conducted by an “environmental professional” who meets certain elevated educational, training and experience requirements (this may limit the number of consultants authorized to perform ESAs and increase the cost)(27).

Table I – ASTM – AAI Element Comparison(28)

ASTM	Issue	AAI
Users identified back to “1 st developed use or back to 1940	Research	Review back as far as “it can be shown that the property contained structures or from the time property was 1 st used for residential, agricultural, commercial, industrial, or governmental purpose
Identifies 8 standard historical sources: aerial photos, fire insurance maps, property tax files, recorded land title records, topographic maps, local street directories, building dept. records, and zoning/land use records	Historical Sources	Environmental Professional judgment determines which specific historical sources are reviewed
Environmental professional explain the reason for any gaps in history of the property use	Data Gaps	Environmental professional must identify data gaps, document all sources of information consulted to resolve data gaps, comment upon significance of gaps.
No specific requirement for research	Abandoned Site	Interviews with 1 or more of owners/occupants of near by properties from which one could observe abandoned properties are mandatory
No specific requirement to interview person who know about prior operations	Interview Past Occupants	Environmental professional should interview current and past facility managers, past owners, occupants or operators, or employees of current and past occupants

Continuing Obligations

Under the new Act, a person must not only conduct a due diligence inquiry under the AAI criteria established under the Act, but must also take “reasonable steps” to stop any continuing release, prevent any threatened future release, and prevent or limit any human, environmental, or natural resource exposure to any previously released hazardous substances. The additional obligations that are necessary for a purchaser to preserve its status as an innocent owner include:

- cooperate with response actions and natural resource restoration;
- comply with and not undermine the effectiveness or integrity any land-use restrictions or institutional controls; and
- provide access to persons authorized to conduct response actions at the facility to operate, maintain, or otherwise ensure the integrity of land-use controls that may be a part of a response action.

Thus, a purchaser can qualify for the innocent landowner defense up-front, but still be compelled to perform certain acts to remain qualified for the protections of the defense.

Conclusion

With every commercial / industrial transaction comes the need for due diligence and a clear understanding of actual and probable environmental liabilities for every purchaser. While the prior ASTM standard and statutory defenses have provided some level of assurance in the past, the various stakeholders have been working together to seek greater clarity and a greater degree of assurance that purchasers could avoid environmental liability. Unfortunately, the most recent changes to the *all appropriate inquiry* standard under the Brownfields Act do not seem destined to provide that greater clarity or appear adequate to ensure that the purchaser will qualify for key environmental liability defenses. In real estate transactions, all parties must be fully

informed on the new AAI standard, the new continuing obligations, and the potential for increased costs associated with both. A purchaser's focus must be the same as before changes to the law, i.e., taking reasonable and appropriate steps to assess the environmental risks associated with a specific site and taking appropriate action to minimize the risk of future liability.

REFERENCES CITED

1. *Site Auditing: Environmental Assessment of Property*, STP Publishers, 2005 edition, Section A.1.
2. “Recognized environmental condition” is defined as the presence or likely presence of any hazardous substances or petroleum product under conditions that indicate an existing release, a past release, or a material threat of release of any hazardous substance or petroleum products into structures on the property or into the ground, groundwater, or surface water of the property.
3. *Texas Practice: Environmental Law*, Vol. 46, § 32.9, 2005 ed.
4. Geltman, Elizabeth, *Environmental Issues In Business Transactions*, Vol. 1, § 2.1, 1995ed.
5. *Id.* at § 2.1.4.1.
6. Federal Register, Vol. 68, No. 90, pg. 24888, May 9, 2003.
7. *Id.* at § 2.1.4.2; see also *Site Auditing* § 3A-1.
8. ASTM standards are reviewed or updated every five years to ensure continued reliability and credibility. This standard was re-approved “as is” in 2002.
9. *Site Auditing*, § 4A-1.
10. Typical liability shifting mechanisms include the following: price adjustment, cleanup prior to closing, risk allocation, liability sharing agreements, indemnification and support mechanisms (bond, letters of credit, escrow accounts, etc), insurance, carve out of contaminated property, and limitations on damages. Geltman, Elizabeth, *Environmental Issues In Business Transactions*, Vol 2. Ch. 26, 1995 ed.
11. *Texas Practice: Environmental Law*, Vol 46 § 32.9.
12. 42 U.S.C §§ 6901 – 6992k; see also RCRA § 7003, 42 U.S.C § 6973.
13. 42 U.S.C §§6991 – 6991i.
14. 15 U.S.C §§ 2601 – 2692.
15. 29 C.F.R. § 1910.1001 and § 1926.58 (construction standards).
16. Tex. Health & Safety Code Ann. § 361.197; La. Rev. Stat. Ann. § 30:2171; Ark. Code Ann. § 8-7-401.
17. See Texas Risk Reduction Program, 30 T.A.C. ch. 350.

18. Tex. Health & safety Code Ann. §§ 361.601 - .613. In addition, Oklahoma Voluntary Cleanup Program contains special provisions that include sites regulated under RCRA, and EPA may suspend response actions for sites being cleanup under the VCP.
19. See La. Rev. Stat. Ann § 30.2225(F), Ark. Code Ann. § 8-7-516, and Ill. Rev. Stat. ch.415 § 5/21.3.
20. Pub. L. No. 99-499, Oct. 17, 1986.
21. The Small Business Liability Relief and Brownfields Revitalization Act [Pub. L. No. 107-118; 42 U.S.C. Sec 19601, et. Seq.].
22. The Brownfields Act provides funding to state brownfields programs and local governments who seek to return contaminated properties to productive use.
23. For property purchased before May 31, 1997, courts must follow a prescribed set of factors, for property purchased after that date but before the EPA promulgates rules, ASTM standards satisfy the requirements for all appropriate inquiry, and for residential property a site inspection and title search that reveal no need for further investigation are adequate.
24. Federal Register, Vol. 69, No. 165, August 26, 2004.
25. Nasi and Abazari, “The Reshaping of CERCLA Liability – Are Landowners Really Better Off?”, Seventeenth Annual Environmental Superconference, August, 2005.
26. See 40 C.F.R. § 312.10, “Environmental Professional:”, Federal Register 26, 2004, Vol. 69, No. 165.
27. The EPA requirements are in accord with the general movement toward professionalizing of environmental auditors (e.g. the Board of Environmental Auditor Certifications and ISO 14015 for site assessment other audit services).
28. All Appropriate Inquiry/Due Diligence, Consultant’s Perspective, Chapin, Bob, Weston Solutions, Inc., Seventeenth Annual Texas Environmental Superconference, August 2005.

