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Essential Environmental Issues in Commercial Real Estate Transactions
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How much environmental investigation and research is warranted for a particular transaction and what exactly should you do? The answers to these questions will vary dramatically from deal to deal. Different types of environmental issues must be considered depending on whether the transaction involves the purchase (and/or financing) of real estate or a business (or both), whether the party you represent is a buyer, seller, investor or lender and particular business concerns driving the deal. In this presentation the panel will focus on issues arising in a typical real estate transfer, that is, the purchase and sale of a parcel of property.

The discussion below addresses the typical scope of the site investigation portion of environmental due diligence and some of the statutory liability protections that follow from a properly conducted investigation.

ENVIRONMENTAL DUE DILIGENCE

Potential exposure to liability under environmental laws is unique as it is often joint and several in nature and attaches to owners of real estate without regard to fault. Thus an otherwise non-culpable party can sometimes be held responsible for environmental conditions at a site -- and if conditions are migrating, beyond the site -- simply by virtue of its ownership interest in the site. In addition, the common law doctrine of *caveat emptor,* while modified by environmental statutes, continues to demand that purchasers carefully investigate potential environmental liabilities associated with a property before taking title.

Given this potential exposure, most real estate transactions will include some level of environmental due diligence. In general, the purpose of environmental due diligence is to identify environmental risks so that the parties to the transaction can effectively quantify and mitigate potential exposure and determine how to allocate these risks.

This discussion focuses on environmental risks associated with site conditions and methods for conducting due diligence that will allow prospective purchasers to take advantage of certain statutory protections from liability. Environmental risks are also typically evaluated in due diligence through other techniques that are beyond the scope of this discussion, for example, investigation of potential compliance issues, land use restrictions and necessary facility upgrades.

In addition to the statutory protections from liability outlined below, Paul McIntyre will explore insurance as another mechanism for alleviating environmental risks associated with real estate transfers. Other methods for allocating environmental liabilities in real estate transactions that are beyond the scope of this presentation include contractual

protections (representations, warranties and indemnifications) and security mechanisms such as escrows.

I. Identify Environmental Risks in Site Conditions

Typically site conditions are evaluated by an environmental consultant through a Phase I (and sometimes a Phase II) environmental site assessment. A Phase I investigation typically consists of a non-invasive inspection of the property (samples usually are not collected), interviews (with tenants, current occupants and sometimes neighboring and past owners and operators of the property) and a records review (including historical, environmental regulatory and other relevant records relating to the conditions a the property).

There are a number of environmental issues relating to site conditions in addition to invasive sampling that are not covered in a standard Phase I investigation. For example, mold, radon, lead-in-drinking water and wetlands concerns may all pose significant risks depending upon the nature and location of the project but are not part of standard Phase I investigation. These parameters are often added to the scope of work for the environmental consultant that conducts the Phase I investigation as they will often impact the budget for the project and/or may have significant liability implications.

The purpose of the Phase I investigation is to identify recognized environmental conditions (or "RECs"), meaning the presence or likely presence of hazardous substances or petroleum products on a property under conditions that indicate a release or material threat of a release. Identification of RECs allows a prospective purchaser of the property to evaluate immediate costs associated with environmental conditions at the property and potential long-term costs and potential exposure to liability to third parties or regulatory agencies.

A properly conducted Phase I investigation will also allow the prospective purchaser to qualify for certain statutory liability protections under the Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C.A. §9601 *et seq.*, commonly referred to as "CERCLA" or the "Superfund" statute.

II. Qualify for Statutory Liability Protections

There are many environmental laws that may apply to a particular real estate transaction. However, one of the most sweeping environmental laws, and the one that drives a lot of environmental diligence on real estate transactions, is CERCLA. Subject to a few limited defenses, Section 107 of CERCLA makes "owners or operators" of a facility strictly liable for releases of hazardous substances. (42 U.S.C.A. § 9607(a)). Such liability is also joint and several with other parties that are "responsible" under the statute for the conditions are the site. (*Id.*).

There are four statutory defenses to (or exceptions from) CERCLA liability that are relevant in the context of a transfer of real estate: (1) the "innocent landowner" defense; (2) the "bona fide prospective purchaser" exemption; (3) the "contiguous landowner" exemption; and (4) the "lender liability" exemption.

As examined in detail below, completion of a properly conducted Phase I investigation is a requirement for the first three of these of these protections from liability. While a Phase I investigation is not required to qualify for the "lender liability" exemption, an investigation will allow a lender to assess the value of the property (and the exposure of the borrower to environmental liability) that often serves as collateral for the loan. Thus a properly conducted site investigation is an important part of environmental due diligence for most transactions.

A. Innocent Landowner

To qualify for the Innocent Landowner defense, an owner must demonstrate that it meets the following three criteria:

1) At the time the owner "acquired the facility [the owner] *did not know or have reason to know* that any hazardous substance that is the subject of the release or threatened release was disposed of on, in, or at the facility." (42 U.S.C.A. § 9601(35)(A)(i) (emphasis added)).

2) The owner had undertaken "*all appropriate inquiries"* into the previous ownership and uses of the facility prior to purchasing the property. (42 U.S.C.A. § 9601(35(B) (emphasis added)). A Phase I investigation conducted in accordance with either the current ASTM standard (ASTM Standard E 1527-05), or the EPA "all appropriate inquiry" regulations (40 C.F.R. pt. 312), will allow a prospective purchaser to demonstrate that it has conducted "all appropriate inquiries."

3) The owner has exercised "*due care*" with respect to hazardous substances once they were discovered on the property. (42 U.S.C.A. §§ 9601(35)(A), 9607(b)(3) (emphasis added)). Exactly what constitutes "due care" is the subject of some controversy, however, the statute clarifies that the owner must demonstrate that it "took precautions against foreseeable acts or omissions of [third parties] and the consequences that could foreseeably result from such acts or omissions." (42 U.S.C.A. § 9607(b)(3)). In general, the "due care" requirement amounts to an obligation not to exacerbate the contamination, or to interfere with the clean up and to cooperate with the parties conducting the remediation.

The innocent landowner defense does not work well in the brownfields context because it requires that the owner seeking to take advantage of the defense to demonstrate that it "did not know or have reason to know" prior to purchasing the property that a hazardous substance had been released (or threatened to release) on the property. (42 U.S.C.A. § 9601(35)). Thus prospective purchasers of brownfields sites, which are by definition known to be contaminated prior to purchase, are not eligible for the defense.

B. Bona Fide Prospective Purchaser

Owners that had knowledge of contamination prior to purchasing the property may nevertheless qualify for an exemption from liability if they meet the criteria of a "bona fide prospective purchaser," sometimes called a "BFPP." BFPP's, although exempt from liability under CERCLA, may find their property subject to a "windfall lien," which

under certain circumstances allows EPA to recover the appreciation of the property value resulting from an EPA response action at the site. Kate Trinward is going to address the windfall lien in greater detail.

To qualify for the BFPP exemption, an owner must meet the following criteria:

1) The owner acquired the facility after disposal of hazardous substances took place.

2) The owner had undertaken "all appropriate inquiries" into the previous ownership and uses of the facility prior to taking ownership.

3) The owner provides all legally required notices with respect to the discovery or release of hazardous substances.

4) The owner exercises "due care" with respect to hazardous substances found at the facility by stopping any continuing release, preventing any threatened future release and preventing or limiting human, environmental or natural resource exposure.

5) The owner provides full cooperation, assistance and access to the parties that are addressing the contamination.

6) The owner complies with land use restrictions and does not impede the effectiveness of institutional controls employed in connection with the response action.

7) The owner complies with any EPA request for information or subpoena.

8) The owner is not "affiliated with" any other person that is potentially liable for response costs.

(42 U.S.C.A. § 9601(40)(B)-(H)). Prior to enactment of the BFPP exemption, prospective purchasers of property with known contamination had to enter into a "Prospective Purchaser Agreement" with EPA in order to ensure that they would be insulated from CERCLA liability. With the adoption of the BFPP exemption, Prospective Purchaser Agreements are no longer widely utilized; although EPA will, in certain circumstances consider entering into a BFPP Agreement memorializing the applicability of the exemption from CERCLA liability and outlining the "due care" requirements for the prospective purchaser.

C. Contiguous Property Owner

CERCLA also has an exemption from liability for owners of property that has been impacted by contamination that has migrated from a neighboring (or "contiguous") parcel.

To qualify for the contiguous property owner exemption, a contiguous owner must meet the following criteria:

1) The contiguous owner *did not cause*, contribute or consent to the release or threatened release.

2) The contiguous owner is not otherwise potentially liable or "*affiliate with*" any other person that is potentially liable for response costs.

3) The contiguous owner takes "*reasonable steps*" to: stop any continuing release; prevent any future threatened release; and prevent or limit human, environmental or natural resource exposure to any hazardous substance released.

4) The contiguous owner provides *full cooperation*, assistance and access to the parties that are addressing the contamination.

5) The contiguous owner *complies with land use restrictions* and does not impede the effectiveness of institutional controls employed in connection with the response action.

6) The contiguous owner complies with any *EPA request for information* or subpoena.

7) The contiguous owner *provides all legally required notices* with respect to the discovery or release of hazardous substances.

8) The contiguous owner had undertaken "*all appropriate inquiries*" into the previous ownership and uses of the property prior to taking ownership.

9) At the time the contiguous owner acquired the property, it *did not know or have reason to know* that the property was or could be contaminated by a release or threatened release from a neighboring property owned by another entity.

(42 U.S.C.A. § 9607(q)(1)(A) (emphasis added)). Like the innocent landowner defense, to qualify for the contiguous property owner exemption, a contiguous owner must not have knowledge of contamination at the time it acquired the property. Nevertheless, in the event that a contiguous property owner is aware of contamination migrating from a neighboring site, it may qualify for the BFPP exemption. (42 U.S.C.A. § 9607(q)(C); 9601(40)).

D. Lender Liability Protections

Lenders have special protection from liability under CERCLA. The term "owner or operator" specifically excludes "a person, who, without participating in the management of a vessel or facility, holds indicia of ownership interest primarily to protect his security interest in the vessel or facility." (42 U.S.C.A. § 101(20)(A), (E)).

The statute unhelpful defines the term "participate in management" as "actually participating in the management or operational affairs of a . . . facility" will result in liability. (42 U.S.C.A. § 9601(20)(F)(i)). Case law has clarified that a level of involvement equivalent to that of an operator will result in liability for a lender.

Nevertheless, the statute clarifies that lenders may take reasonable steps to protect their interest and ensure that their lenders are acting responsibly with regard to environmental issues without jeopardizing their statutory protection. Thus a lender may, for example, include (and enforce) environmental covenants and warranties in the loan documents, monitor or inspect to facility and require response actions to address a release of a hazardous substance. (42 U.S.C.A. § 9601(20)(F)(iv)).