Environmental Risk in Today's Market

by Donald C. Nanney

"Courage is: Being scared to death – and saddling up anyway."
- John Wayne

On the heels of environmental law and regulation came fear. Fear of environmental liability led to fallow properties called "brownfields." The redevelopment of such properties is complicated by the real or perceived presence of hazardous substances, pollutants, or contaminants and the risk of unlimited liability under stringent regulatory standards. These properties tend to be in urban areas where the opportunity and the need to recycle them to productive use is greatest. What techniques are available so that, even scared, we can "saddle up anyway" with a realistic hope of surviving, even profiting and surely benefitting the economy by turning around a brownfield property?

ECONOMIC & POLITICAL TRENDS

Available techniques are shaped by economic and political trends. The advent of the fear of environmental liability was followed by the real estate recession of the early to mid-1990s. Brownfield properties languished as potential buyers, redevelopers, and lenders (lacking John Wayne's courage) generally took a risk-averse, hands-off attitude. However, later in the 1990s, brownfields again became targets for acquisition and redevelopment due to the stronger real estate market coupled with scarce available land for development in urban areas. Environmental risks that were previously avoided have become a hot topic for assessment, negotiation, and allocation between transaction parties.

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The trend toward a stronger market in contaminated property was complemented, and in part impelled, by political developments. Recognizing the connection between the strength of the economy and longevity in public office, politicians pressured environmental regulators to ameliorate the impact of potential environmental liability in order to encourage the recycling of brownfields to productive use and to expand the employment and tax base of affected communities. Governmental initiatives were undertaken at both federal and state levels in response to these economic and political pressures, as highlighted in *Exhibit 1*. Regulators—who previously caused the fear by unreasonable, absolutist application of environmental regulations leading to uncontrolled costs and liability—had a change in attitude and adopted more reasonable policies. Relationships with regulators are still not completely without distress for landowners and developers, and attitudes vary depending upon the circumstances. But in general it is much more possible now to deal with environmental problems with all parties, including the regulators, working toward the common objective of resolving the environmental problem on a cost-effective basis and restoring the property to productive use.

If you wish to deal with environmentally impacted properties, it helps to have an appreciation for the economic and political background of current market trends, and how those trends are reflected in your area, including applicable regulations, policies, and attitudes, in order to know what is possible in a particular situation.

CONTRACTUAL ALLOCATION OF ENVIRONMENTAL RISK

Site Assessment. The first step in dealing with environmental risk is to learn as much as reasonably possible about the condition of a property through environmental site assessment by qualified professionals. Also, the seller must disclose known contamination as required by applicable environmental laws and to avoid common law fraud claims for nondisclosure of "material" facts. Sellers may fear the prospect of triggering reporting duties and regulatory oversight as a result of the discovery of contamination during site assessment. But the alternative is not to market the property, so the seller must overcome that fear. Except in the worst of cases, problems that are already known or are discovered through due diligence can usually be quantified and allocated between the parties in some mutually acceptable fashion. The handling of known problems has been made more feasible by improvements in remedial technologies and greater experience in developing accurate cost estimates. It is the unknown, unquantified risk that usually poses the most difficulty in deal negotiations. Site assessment can narrow down but cannot completely eliminate the unknown. There are a number of ways of handling unknown risk.

Deal Structure. The risk of inheriting unexpected environmental liability can be minimized by structuring the deal as an asset acquisition rather than a stock acquisition. The general rule is that an asset purchaser acquires the asset, not the liabilities of the seller. A purchaser of stock becomes the owner of the company, including its liabilities. The surviving entity in a corporate merger has both the assets and the liabilities of the previous entities. Many corporate transactions have been done without regard to environmental liability, and many new owners have experienced the unwelcome surprise of liability for past disposal of hazardous waste at dump sites that are now the subject of cleanup. Liability for previous off-site disposal can be avoided by structuring the deal as an asset acquisition.

Deal structure can also make a difference when it comes to liability for on-site conditions. If the site proves to be contaminated, a purchaser of the site may be able to establish the "innocent purchaser" defense to avoid or minimize liability. That defense will not be available to a purchaser of stock or the survivor of a corporate merger. Also the risk of future discovery of presently unknown contamination can be allocated between the parties contractually.

Allocation Strategies. Using the devices of contractual representations, warranties, indemnities and releases, environmental risk can be allocated in numerous ways between transaction parties. A range of possible strategies is highlighted in *Exhibit 2*. Entrepreneurs targeting brownfields properties typically assume some or all of the environmental risk associated with a property. However, they usually require thorough site assessment to identify the scope of the risk. Also, they usually require a sufficient price discount so that the remedial cost can be recovered, together with a profit margin, through an increase in market value as a result of the cleanup. Such entrepreneurs often use environmental insurance to limit their risk by shifting a portion of it to an insurance company. New environmental insurance products are available to close the risk gap between transaction parties and make a deal possible.

Contract Forms. It is necessary with each transaction to consider carefully how the risk should be allocated and to make sure that the contract accurately reflects that allocation. While there are many "right" ways to allocate risk (whatever is mutually acceptable), it would be "wrong" not to tailor the allocation to the situation. Allocation can be affected by prevailing market conditions (sellers' vs. buyers' markets) as well as the respective business motivations of the parties. How the risk can and should be allocated can vary with those external and internal influences. It is a common mistake to treat the environmental clauses of a "standard" form purchase and sale contract as boilerplate to be used without further thought. While that may save transaction costs at the moment, such clauses were likely developed under different economic conditions and circumstances, and you (or the other side) might be able to do significantly better under current conditions. You should not miss that opportunity.

NEW ENVIRONMENTAL INSURANCE PRODUCTS

The following environmental insurance products may be of most relevance at the time of a real estate transaction:

- *Property Transfer* or *Environmental Review* coverage insures the results of environmental site assessment against the risk of future discovery of unknown conditions not identified during the assessment.
- *Remediation Warranty* or *Cost Cap/Stop Loss* coverage insures against cost overruns during implementation of an approved remedial action plan, up to policy limits after exhaustion of the initially estimated cost of the remediation plus a self-insured retention. That margin of retained risk over estimated cost is much narrower than it used to be, due to more experience and confidence in cost estimating for remedial action.
- *Post-Remediation Warranty* or *Reopener* coverage insures against the risk that regulatory standards may change or that additional contamination may be discovered leading to further remedial action requirements notwithstanding a previous "no further action" determination.

There are other relevant coverages, such as for underground storage tanks, asbestos in buildings, pollution legal liability, first party cleanup coverage, remediation consultants, and contractors. Environmental insurance can be an important element of managing environmental risk and possibly making a deal happen that would not otherwise be feasible.

The growing importance of environmental insurance is illustrated by pending litigation in Los Angeles where one of the oldest and most prestigious law firms (O'Melveny & Myers) has been accused by its former client, the Los Angeles Unified School District, of having failed to advise the school district about the availability of environmental insurance. The school district acquired a 35-acre site in the shadow of downtown Los Angeles for the construction of the Belmont Learning Center, a much-needed new high school facility. The school district assumed full environmental risk for the site without the benefit of environmental insurance. After expending nearly $200 million, the school district abandoned the project due to the risk of methane gas and hydrogen sulfide from the old oil field at the site. The acquisition was completed allegedly without adequate site assessment, and the construction proceeded without utilizing available systems for controlling soil gasses. An enormous cost would be associated with retrofitting a huge complex of buildings with gas control systems. An insurance company likely would have declined to issue a policy without more assessment, or might have excluded coverage for the known risk of gasses from the oil field unless adequate controls were installed. That could have served as a danger signal to the school district before the acquisition or before the commencement of construction.

FORECAST

Given the influence of economic and political factors, there is a risk that regulatory attitudes may stiffen again. Some people believe that in good economic times the public becomes more concerned about the quality of the environment, with politicians and regulators following suit, and that in lean economic times, jobs and the economy become the primary concern with the environment suffering. If so, one can expect the attitude of environmental regulators to swing back and forth like a pendulum in sync with the ebb and flow of the economy.

However, this was not borne out during the recent period of economic good times. Cooperative attitudes still seemed to prevail where possible. Perhaps the last recession was too fresh to be forgotten. Also, the Federal Reserve Board exercised its monetary policy powers to raise interest rates to control the economic expansion in hopes of avoiding more boom and the inevitable bust. At time of writing in

(Continued on page 34)

Exhibit 1

GOVERNMENTAL INITIATIVES

Federal Initiatives

Brownfield initiatives at the federal level include the following:

- ***Lender liability policy***. The U.S. Environmental Protection Agency (EPA) adopted a safe harbor rule for lenders to ameliorate their concern about potential liability under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA). See the Final Rule on Lender Liability Under CERCLA, published at 57 Fed. Reg. 18344, April 29, 1992, and codified at 40 CFR §§ 300.1100 and 300.1105. But that rule was voided as beyond the EPA's authority (Kelley v. EPA, 15 F.3d 1100 (D.C.Cir. 1994)). The EPA and Department of Justice (DOJ) later issued the "Policy on CERCLA Enforcement Against Lenders and Government Entities that Acquire Property Involuntarily" reaffirming the EPA's and DOJ's "intentions to follow the provisions of the Lender Liability Rule as enforcement policy" notwithstanding the Kelley case. See 60 Fed. Reg. 63517 (Dec. 11, 1995). Congress subsequently adopted key elements of the safe harbor as a matter of law. See the Lender Liability and Deposit Insurance Protection Act of 1996, Title V of the Omnibus Consolidated Appropriations Act of 1997, amending 42 U.S.C. §§ 9601 and 9607.
- ***Innocent landowners***. The EPA adopted the "Policy Towards Owners of Property Containing Contaminated Aquifers," which provides that no enforcement action will be taken against innocent landowners whose property is contaminated solely due to subsurface migration from offsite sources. 60 Fed.Reg. 34790 (July 3, 1995). This policy is easy for the EPA to adopt in light of the third-party defense under CERCLA. But there may be some comfort in hoping that the EPA will live up to its "policy" and not initiate enforcement action, rather than having to prove the defense.
- ***Residential property***. The "Policy Towards Owners of Residential Property at Superfund Sites," OSWER Directive No. 9834.6 (July 3, 1991), is like the preceding item, but applies to residential property.
- ***Comfort letters***. The EPA adopted a policy making available status/comfort letters for individual properties and transactions. Such letters set forth EPA's view of current site status and enforcement intentions and approaches. Such letters are nonbinding, but still may be comforting. Although the policy exists, resources remain limited and it might be difficult to get the EPA's attention to issue such a letter for a site with respect to which the EPA otherwise has no interest.
- ***Prospective purchaser agreements***. These are formal, binding agreements that can define and limit the scope of the environmental risk to be assumed by a purchaser of contaminated property. Such agreements are limited regarding the kind of site and still may have qualifications and reopener provisions. The criteria (set forth in 60 Fed.Reg. 34792, July 3, 1994, replacing the original 1989 guidance) are as follows:
  - There is federal interest in the site, in that EPA action is being taken, is ongoing or is anticipated as to the site.
  - EPA and the community will receive some substantial benefit (*e.g.*, cleanup by purchaser, new employment opportunities).
  - Continued operations or new development at the site will not, with exercise of due care, aggravate or contribute to contamination or interfere with ongoing or future EPA response action, and will not pose health risk to the community or persons at the site.
  - The prospective purchaser is financially viable.

  The key elements of a prospective purchaser agreement are: consideration from the purchaser (monetary payment and/or defined cleanup obligation); EPA covenant not to sue the purchaser; protection for the purchaser against contribution actions by other responsible parties; and transferability to subsequent purchasers or tenants.
- ***Database purging***. The EPA has purged the CERCLIS database of almost 25,000 of the 38,000 sites listed that are No Further Remedial Action Planned (NFRAP) properties. The intention was to destigmatize those properties. Nevertheless, secondary databases maintained by environmental information companies were apparently not purged, and Phase I Environmental Site Assessment reports often continue to show both the CERCLIS and NFRAP listings.
- ***Risk-based corrective action***. Land Use OSWER Directive No. 9355.7-04 (May 24, 1995), requires the government to consider future land use when assessing risks, developing cleanup plans and choosing the most appropriate remedy for Superfund site cleanup.

Exhibit 1, *continued*

- ***Tax treatment of cleanup expenses.*** On March 11, 1996, President Clinton announced a $2 billion, seven-year tax incentive program to encourage brownfield redevelopment by allowing brownfield investors to deduct their cleanup expenses in the year incurred and reduce the net cost of such investment, when much of such costs might otherwise be treated as capital items not deductible in full in the year incurred.
- ***Pilot projects.*** In December 1999, the EPA announced the RCRA Brownfields Prevention Initiative under which the EPA is expediting cleanup at pilot project sites using innovative approaches. The objective is to show how the reform of corrective action approaches under the Resource Conservation and Recovery Act of 1976 (RCRA) (42 U.S.C. §§6901 et. seq.) can encourage redevelopment of brownfields.
- ***Legislative reform.*** Many of the policy initiatives can be viewed as efforts by the regulators to respond to the economic and political pressures while preserving the environmental statutes against reversal. Still, legislative reform of CERCLA is a perennial subject on Capitol Hill, lately with an emphasis on seeking a variety of ways to stimulate and encourage redevelopment of brownfields. For instance, the following bills are pending in the 107th session of Congress:

S. 1079	Brownfield Site Redevelopment Assistance Act of 2001
S. 1078	Brownfields Economic Development Act of 2001
S. 350	Brownfields Revitalization and Environmental Restoration Act of 2001
H.R. 2064	Brownfields Redevelopment Incentives Act
H.R. 1831	Small Business Liability Protection Act
H.R. 1439	Brownfields Clean-Up Act

It remains to be seen which, if any, of these bills will survive the legislative process and be enacted into law, and what liability relief and encouragement they will bring. The text and current status of these bills can be found on a Library of Congress Web site called Thomas Legislative Information on the Internet (at http://thomas.loc.gov).

State Initiatives

Brownfield initiatives at the state level include the following ***(using California for illustration):***

- ***Lender liability relief.*** California has adopted lender liability relief analogous to the federal CERCLA amendments noted above. See Health and Safety Code §§ 25548 et seq.
- ***Redevelopment agencies.*** Under certain conditions, redevelopment agencies are immune from liability under state and local environmental laws, and the immunity extends to certain persons entering into development agreements for a brownfields site, their successors in title, and persons financing the project in a redevelopment area. Health and Safety Code §§ 33459-33459.8.
- ***Special legislation.*** Special legislation was adopted for the Kaiser Steel Corporation Site in Fontana, California, to facilitate redevelopment by establishing procedures whereby certain parties could be released from liability. Health and Safety Code § 25364.1 (1992). The release, effective January 1, 1995, extended to cost recovery liability to the State under CERCLA, the State Hazardous Substance Account Act (Cal/Superfund) and the Hazardous Waste Control Act.
- ***Unified agency review.*** Under AB 2061 (Health and Safety Code § 25260-25268), a responsible party may obtain designation of a single state or local "administering agency" to oversee a project. Upon completion, the agency must issue a certificate of completion that operates like a statutory release from any further liability subject to specified reopeners. The statutory release does not apply to federal claims, only claims under state law. This law was enacted to deal with the problem of multi-agency jurisdiction and inconsistent or conflicting requirements.
- ***Pilot program.*** A pilot program was adopted for the streamlined cleanup of up to 30 sites under SB 923, the California Expedited Remedial Action Reform Act of 1994 (Health and Safety Code §§ 25396-25399.2). That law provides incentives designed to speed cleanups, such as: set time frames for agency reviews of submissions; more flexibility in remedy selection consistent with site-specific goals and "planned use" of the property (no preference for treatment except for "hot spots"); rights to dispute agency technical decisions; provision for liability allocation and state funding of "orphan shares"; mutual covenants not to sue; and future liability protection under a certificate of completion under AB 2061. Depending on the success of this pilot program, its features may become adopted more generally.

Exhibit 1, *continued*

- ***Environmental use restrictions***. Under AB 1120 (Civil Code § 1471, effective January 1, 1996), owners of land are authorized to impose restrictions limiting the use of contaminated property, with the restriction running with the land and binding future owners and occupants, for protection of human health and safety.
- ***CLEAN Program***. In 2000, California enacted the Cleanup Loans and Environmental Assistance to Neighborhoods (CLEAN) Program to provide up to $85 million in low interest loans to help with the cleanup and redevelopment of abandoned or underutilized urban sites. The program is administered by the state Department of Toxic Substances Control (DTSC).
- ***The California Land Reuse Accord***. Senate Resolution No. 29–The California Land Reuse Accord, adopted July 14, 1995, encourages cooperative and expeditious solutions by all interested parties in order to remediate properties contaminated with hazardous waste and return them to productive use.
- ***Voluntary Cleanup Program (VCP)***. In order to facilitate brownfield redevelopment, this program departs from the "worst first" policy for allocation of Cal/EPA Department of Toxic Substances Control (DTSC) resources and allows a remediation project proponent to obtain DTSC oversight and cooperation. The VCP also contemplates shorter time frames for site investigation and remediation, which may accommodate development schedules and financing arrangements. Cleanups under the VCP are deemed "consistent" with the National Contingency Plan (40 CFR Part 300), facilitating cost recovery from other responsible parties. The VCP emphasizes use of presumptive remedies and innovative technologies to expedite remediation. But site-specific cleanup goals are utilized. Agreements under the VCP can clarify many of the issues that have posed difficulty. Upon completion, DTSC issues a "no further action letter" or a certificate of completion (short of a release or covenant not to sue).
- ***Prospective purchaser agreements***. DTSC (and other state agencies) may enter into prospective purchase agreements including covenants not to sue. The criteria are similar to those with the EPA's policy, but the state criteria are more flexible and of broader potential applicability. DTSC may also issue "comfort" letters. But, like the EPA, it may be difficult to get the attention of the DTSC to issue such a letter for a "pure" real estate transaction involving property that is not of concern to the regulators.
- ***CalSites Validation Program***. DTSC has deleted more than 21,000 sites from more than 26,000 potential sites on the CalSites list.
- ***Innocent landowners***. Like the federal policy, it is the policy of the state not to take enforcement action against innocent owners of property under which a plume of contaminated groundwater has migrated. Management Memo No. 90-11 (Dec. 7, 1990).
- ***Legislative reform***. Much like the Congress as noted above, the California legislature is actively considering ways to encourage redevelopment of brownfields. For instance, currently pending is S.B. 32, the California Land Environmental Restoration and Reuse Act. Another pending bill is A.B. 254, which would liberalize the CLEAN Program in certain ways to stimulate its use (such as by allowing some relief regarding the payment of DTSC oversight costs, designating the regional water quality control board as the oversight agency in some circumstances, permitting use of loan funds to pay a premium for environmental insurance, loosening the eligible property criteria, lengthening the loan repayment period, delaying the start of the loan repayment period, and allowing for other forms of security or for DTSC to have lower than first lien priority for the loan when the property being cleaned up is the security). S.B. 232 is also pending, which would establish the Financial Assurance and Insurance for Redevelopment (FAIR) Program seeking to make environmental insurance for brownfield redevelopment more available and more affordable. If enacted, a FAIR Account would establish and fund, with continuous appropriations, up to $37.5 million in order to subsidize premiums and to cover a portion of self-insured retention under certain kinds of environmental insurance products. The text and status of these bills can be found at the state Web site for Official California Legislative Information (at http://www.leginfo.ca.gov/).

One or more of these initiatives, as applicable, can be utilized to provide a measure of protection, or at least comfort, allowing a transaction to proceed. Still, brownfield redevelopment remains hampered by agency funding constraints, multi-agency coordination issues, policy uncertainty, and timeliness problems. Some regulators would rather require more site assessment and more remedial work than make a decision that enough is enough. Much remains to be done to solve the gridlock and paralysis associated with brownfield development, but we are much better off than we were before these initiatives were adopted.

Exhibit 2

Environmental Risk Allocation Strategies

- No express allocation (let chips fall where they may under applicable law, on some or all environmental aspects).
- Seller retains all risk.
- Buyer assumes all risk ("as is" sale plus release and indemnity to seller).
- Seller retains risk of all or certain "known" problems, buyer assumes "unknown" risks.
- Responsibility divided as of date of sale, preexisting vs. future conditions (requires good "base-line" site assessment).
- Sliding scale mutual indemnity (seller retains share of responsibility, reducing over agreed period after which buyer assumes all risk).
- Cleanup and "no further action" determination as condition of closing, or as post-closing covenant.
- Prospective purchaser agreements with applicable federal and state agencies (consideration paid by seller, buyer, or shared).
- Monetary holdback in escrow for remedial cost of known conditions.
- Deductibles (buyer's costs must exceed an agreed sum before seller's indemnity kicks in).
- Monetary caps (seller's indemnity has a limit after which the buyer assumes the risk).
- Scope of environmental indemnity (cleanup costs vs. economic losses vs. personal injury or toxic tort liabilities; onsite vs. offsite conditions).
- Duration of contractual protection: indefinite vs. termination provision (*e.g.*, completion of agreed cleanup, agreed time period).
- Use restrictions to limit risk of exposure to future occupants (*e.g.*, no drinking water well, no excavation below a given depth).
- Environmental insurance for unknown risks, in lieu of or in addition to contractual indemnities (premium paid by seller, buyer, or shared).
- Purchase price adjustments based on allocation of risk.
- Any combination of the foregoing.

Continued from page 30

fall 2001, the economic expansion has foundered. The stock market has reversed course after a period of years of growth. While still active, the glow is off the hot real estate market of the last few years, with mixed results. For instance, the sudden collapse of many high-flying "dot.com" companies has had a downward impact on the real estate market in certain locations where rents were soaring one year ago. The Federal Reserve Board has cut interest rates in hopes of a "soft landing" and rebound. The effect is that the boom time mentality is in check and we remain cognizant of the prospects for recession. This should be the case even more if the U.S. economy slips fully into recession in the aftermath of the September 11 tragedy and subsequent hostilities. The scope, extent, and duration of the hostilities and the economic impact remain to be seen.

Governmental attitudes should remain cooperative, balancing environmental concerns and economic needs, as politicians seek ways to stimulate the economy. We can expect the government at all levels to be supportive of brownfield redevelopment, especially in blighted and environmentally impacted urban areas where the need to recycle properties is the greatest. Cooperative attitudes should continue even as economic conditions improve and notwithstanding fluctuations in the economic cycle, as long as there is demand for redevelopment of such areas.

The main threat at this point is not governmental attitudes; it is the availability of financing for projects involving environmentally impaired property if there is a period of deep recession. Assuming that financing is available, the climate should be favorable for the redevelopment of brownfield properties. Thus, the lesson is clear, now is the time to consider the recycling of brownfield properties before economic and political forces change sufficiently to work against such projects. Have courage and saddle up!$_{REI}$

NOTE

The author is expressing views of general academic interest, without any reflection as to how he or his firm would view any particular property, situation, or case. The views expressed are the author's and not necessarily those of his firm.