

Environmental Due Diligence in the Wake of the EPA's New All Appropriate Inquiry Rule

BY DIANNE CROCKER

AS ANY SEASONED DEALMAKER KNOWS, there are regulatory hurdles that need to be addressed before initiating any transaction. Now, we can add a new environmental regulation to the list. Purchasers of commercial property and those who receive site-specific brownfields grants must follow a new federal rule governing environmental due diligence if they wish to obtain federal liability protection.

The U.S. Environmental Protection Agency's All Appropriate Inquiry rule took effect Nov. 1, 2006, and lays out the type of research that dealmakers—and their environmental consultants—must conduct upfront to avoid paying for any past environmental contamination on a property. Still in the early stages of adoption, the AAI rule has generated a great deal of uncertainty in commercial real estate circles as dealmakers, their lenders, consultants and other stakeholders interpret and implement the new protocol for environmental due diligence.

Outside the environmental consulting world, awareness about what steps commercial real estate purchasers must take to avoid cleanup liability is far from widespread, and there seems to be more questions than answers. Following are the facts that every real estate investor should know about the EPA's new rule.

ENVIRONMENTAL CLEANUP LIABILITY: A BRIEF HISTORY

Enacted in 1980 to address the nation's most polluted sites, the Comprehensive Environmental Response, Compensation and Liability Act makes so-called potentially responsible parties liable for the cleanup of contaminated properties, even if they didn't contribute to—or

know about—the contamination. Understandably, the act, also called Superfund, caused considerable alarm among real estate investors.

In response, the U.S. Congress passed amendments to CERCLA in 1986 that included the “innocent landowner” defense, a provision that exempts site owners from liability if they didn't know, or have reason to know, of contamination at the time of purchase. The defense can be raised, provided that the purchaser conducted environmental due diligence, or “all appropriate inquiry” on the property upfront. Until the AAI rule was passed, this step was accomplished with an ASTM E 1527-00-compliant Phase I environmental site assessment.



About the Author

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ENTER AAI

In 2002, Pres. George W. Bush signed into law the Small Business Liability Relief and Brownfields Revitalization Act. Also known as the Brownfields Amendments, the act sought to encourage the redevelopment of brownfields, which the federal government describes as “abandoned, idled or underused industrial and commercial properties where expansion or redevelopment is complicated by real or perceived environmental contamination.”

To help meet its redevelopment goal and mitigate concerns developers had about being held liable for property contamination, Congress created two new CERCLA liability protections. The “bona fide prospective purchaser” defense provides protection for property owners who knowingly purchase contaminated property, provided they can demonstrate that any onsite contamination occurred before purchase; and the “contiguous property owner” defense provides liability protection for an owner from contamination caused by the migration of hazardous substances from an adjacent property, provided the owner demonstrates that he or she did not know of contamination on his or her property at the time of purchase.

Particularly noteworthy, the bona fide prospective purchaser protection marks the first time owners can take title to a property they know to be contaminated and still qualify for CERCLA liability protection down the road.

Within the Brownfields Amendments, Congress ordered the EPA to issue a federal regulation defining all appropriate inquiry; it then gave the EPA a 10-step framework to follow in drafting the rule. The Nov. 1, 2005, promulgation is a result of considerable effort by the agency’s 25-member AAI stakeholder committee. The final rule, which includes a lengthy preamble, reflects changes made to the draft rule in response to more than 400 public comments solicited by the agency during a 90-day period in 2004.

WHAT DOES AAI ENTAIL?

The most pressing question facing commercial property purchasers is: “Just what do I need to do to protect myself?” Though the 2002 Brownfields amendments were designed to give prospective purchasers an incentive for new investment opportunities, particularly for sites with known contamination, they also impose new obligations under AAI—burdens for the user, i.e., the property

Table 1
**Distribution of Responsibilities
for AAI Components**

DUTIES OF ENVIRONMENTAL PROFESSIONAL

- Conduct an environmental inquiry that includes:
 - visual inspections of the facility and adjoining properties
 - interviews with past and present owners, operators and occupants
 - reviews of historical sources
 - reviews of federal, state, tribal and local government records

DUTIES OF USER

- Searches for recorded environmental cleanup liens
- Consideration of “specialized knowledge of the subject property and adjoining properties”
- Consideration of the relationship of the purchase price to the value of the property, if not contaminated

SHARED DUTIES OF ENVIRONMENTAL PROFESSIONAL AND USER

- Consideration of “commonly known or reasonably ascertainable” information about the property
- Consideration of the “degree of obviousness of the presence or likely presence of contamination at the property”

purchaser, and the environmental professional chosen to conduct the inquiry (see Table 1).

Before even getting started on AAI, property purchasers must choose a qualified environmental consultant. Under the AAI rule, environmental professionals must meet specific requirements for experience, education and certification as defined by the EPA (see Table 2). Individuals who do not meet these requirements may participate in

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Table 2

AAI Rule's Final Definition of Environmental Professional

PROFESSIONAL AND EDUCATIONAL QUALIFICATIONS		RELEVANT FULL-TIME EXPERIENCE*
Hold a current professional engineer's or professional geologist's license or registration from a state, tribe or U.S. territory	AND	Three years
OR		
Be licensed or certified by the federal government, a state, tribe or U.S. territory to perform environmental inquiries	AND	Three years
OR		
Have a baccalaureate or higher degree from an accredited institution of higher education in science or engineering <i>(broadened from the proposed definition which was limited to "engineering, environmental science or earth science")</i>	AND	Five years
OR		
None <i>(revised to delete baccalaureate degree requirement as of the date of the rule's promulgation)</i>	AND	10 years

**Relevant experience is defined as: participation in the performance of AAI investigations, environmental site assessments or other site investigations that may include environmental analyses, investigations and remediation that involve the understanding of surface and subsurface environmental conditions and the process used to evaluate these conditions, and for which professional judgment was used to develop opinions regarding conditions of releases or threatened releases to the subject property.*

an environmental inquiry, but only if they are under the supervision of someone who does.

An AAI-compliant Phase I report must carry the signature of the environmental professional who conducted or supervised the work, and that individual must attest that he or she meets the EPA's requirements. For their own protection, all individuals investing in commercial property should ensure that the firm they hire has at least one person on staff who meets AAI's definition of environmental professional.

RESPONSIBILITIES OF THE ENVIRONMENTAL PROFESSIONAL

Much of AAI's requirements go beyond its predecessor,

ASTM standard E 1527-00, which until Nov. 1, 2006, satisfied the courts that all appropriate inquiry had been conducted. (EPA determined that ASTM's recently updated standard, E 1527-05, is sufficient protocol for conducting all appropriate inquiry. Both an AAI-compliant Phase I and an E 1527-05-compliant Phase I satisfy the AAI rule's requirements.) The revisions to the E 1527-00 standard to bring the practice in line with the requirements of the AAI rule were made under the guidance of EPA reviewers.

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In the end, the EPA was satisfied that the new standard practice was at least as stringent as the federal rule and is, therefore, recognized as acceptable practice. This was a significant development because it would minimize any market impact of the AAI rule by allowing the market to adjust to a revised version of a practice that was already widely used. There are, however, a number of areas where the new AAI rule and E 1527-05 differ from the ASTM predecessor, in some cases significantly.

One of the most significant changes under AAI that commercial property investors should be aware of is the added scrutiny that must be placed on any gaps in the environmental investigations.

In terms of records review, the AAI rule expands the level of inquiry, requiring all previous ASTM-required records *plus* those from local government agencies and Native-American tribes. What's more, the environmental professional will have to search for engineering and institutional controls—i.e., restrictions on a property's use because of residual contamination on site—a function the environmental professional and the user share.

In terms of historical research, AAI's requirements are more loosely laid out than previous protocol, but not necessarily less strict. Research timeframes, data sources and search intervals are left to the judgment of the environmental professional, but research must go back as far as "it can be shown that the property contained structures or from the time the property was first used for residential, agricultural, commercial, industrial or governmental purposes."

One of the most significant changes under AAI that commercial property investors should be aware of is the added scrutiny that must be placed on any gaps in the environmental investigations. Unlike E 1527-00, under the AAI rule, the environmental professional must address, document and explain any data gaps—defined as "a lack of or an inability to obtain information required by the standards and practices listed in the (AAI rule) despite good faith efforts by the environmental professionals or (user) to gather such information."

Documentation should include a summary of the information the environmental professional had to work with, and a detailed account of what could not be obtained as well as documentation of the sources conducted to fill the gaps and, perhaps most important, a determination of the effect that said gaps have on the environmental professional's ability to draw conclusions about contamination at the subject property. This requirement to research, document and analyze the significance of data gaps will add considerable time and expense to the Phase I inquiry.

The AAI rule states that one way environmental professionals can address data gaps is to take soil and groundwater samples. Sampling is not required, however. Rather, the burden is on the environmental professional to determine the significance of gaps in information and recommend additional investigation including sampling, if necessary.

During the rule's public comment period, many environmental consultants objected to the idea of sampling, an activity traditionally seen as beyond the scope of a Phase I. Mark Fackler, president of Azland Risk Management LLC, an environmental engineering firm in Louisville, Ky., won't recommend sampling unless his clients request it. "The new standard specifically excludes Phase II sampling activities in its scope," he says.

Jane Mills, a senior environmental engineer based in the Redmond, Wash., office of Golder Associates, concurs. "Sampling of suspect hazardous materials should not be required as part of a preliminary site assessment. As a consultant, it is difficult to accurately predict the extent of sampling required at a site prior to the preliminary site assessment," she says.

Some environmental consultants, like Elizabeth Krol, a client program manager in Shaw Environmental & Infrastructure's Hopkinton, Mass., office, will sample in certain cases. "I will recommend sampling if it is warranted, but not as a routine practice without a trigger or issue that requires further investigation." Her colleague Gary Sirota, who is based in Scottsdale, Ariz., and serves as Shaw's national program manager of due diligence, agrees. "I would recommend sampling if it was necessary to fill a data gap."

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When working with an environmental professional, commercial property purchasers should keep in mind that they will be held responsible for managing contamination responsibly. Like Krol, Kevin Billings, P.E., a senior vice president with Property Solutions Inc. in Moorestown, N.J., says he'd recommend sampling to fill data gaps, but adds: "Some clients will not like this, especially in the case of groundwater in urban areas where contamination may be picked up from off-site issues that do not really affect the utility of the property. In some states, you must notify the regulators that you found contamination on your property that you think is from someone else. Then you must prove your innocence. Eventually, the state may agree, but by that time, you have spent a good deal of money."

Real estate investors should weigh the question of whether to sample carefully. Though not required under the AAI rule, there is a business advantage to sampling in advance of purchase to identify all potential environmental concerns before taking title.

USER RESPONSIBILITIES

Like the environmental professional, the commercial property purchaser has obligations under AAI that go above and beyond previous requirements. Among these, the purchaser must inform the environmental professional about any environmental cleanup liens filed or recorded against the site, any activity and use limitations in place, any specialized knowledge or experience related to the property or nearby properties, the relationship of the purchase price of the property to its value if not contaminated, any commonly known or reasonably ascertainable information about the property and any obvious indications pointing to the presence or likely presence of contamination at the property.

Though this list of obligations sounds onerous enough, the user's duties don't stop on the date of purchase. The EPA makes it clear in the rule's preamble that to maintain CERCLA liability protection, the property owner must also keep up with so-called continuing obligations throughout the life of the property. These obligations include:

- Complying with land use restrictions and institutional controls

- Taking reasonable steps with respect to hazardous substances releases
- Providing full cooperation, assistance and access to persons authorized to conduct response action or natural resource restoration
- Complying with information requests and administrative subpoenas
- Providing all legal required notices

Though not required under the AAI rule, there is a business advantage to sampling in advance of purchase to identify all potential environmental concerns before taking title.

Property owners must comply with any land use restrictions on the property and must not impede the effectiveness or integrity of an institutional control at the property. (An institutional control, or IC, is a type of land-use control that is used when the presence of residual contamination on a property precludes its unlimited use.) Such a control might be in effect to prohibit the disturbance of contaminated soils in a particular portion of the property.

If the owner is unaware of the control and develops the restricted portion of the property, he or she could forfeit CERCLA liability protection, even if AAI was followed before purchase. Impeding the effectiveness or integrity of an IC does not necessarily require a physical disturbance or disruption of the land, though. A landowner could also harm the implementation of an IC through actions that are unrelated to land use restrictions, such as removing a notice conveying information about contamination on a site that was placed in the land records by the EPA or a state agency, or failing to give notice of any ICs to a subsequent purchaser, for example.

With regard to hazardous substance releases, if they occur, property owners must:

- Stop any continuing release
- Prevent any threatened future release

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- Prevent or limit human, environmental or natural resource exposure to earlier hazardous substance releases

Commercial property owners are responsible for complying with any restrictions on the use of their properties *even if those restrictions were not identified in pre-purchase environmental due diligence*. CERCLA liability protection can be lost at any time if continuing obligations are not met.

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Just how difficult will it be for a property owner to follow these continuing obligations? From a practical standpoint, it could be fairly difficult, especially when owners and operators try to interpret what EPA considers acceptable. "Questions will be raised and different interpretations will be put forth. Unfortunately, it may take lawsuits to shake out the requirements," Billings says. Sirota agrees: "Many clients do not have a clear understanding of what the requirement actually means to them and what specific actions or responses they are required to make."

Krol has a similar belief. "I suspect that there is less awareness (among property purchasers) of the continuing obligation requirements. I think that if there is a significant enough issue that warrants ongoing activity—such as quarterly groundwater monitoring—this would be discovered during thorough due diligence, and the new owner would have both awareness and understanding that they must continue this work to remain in compliance. Alternatively, they may negotiate responsibility with the seller, who could continue to do the necessary work. In that case, I would advise my client to either be copied on submittals or do periodic state agency file reviews, etc., to ensure that the seller has met its obligation and that the owner is protected."

Because of the additional ongoing obligations required by the AAI rule, the Phase I report takes on new significance. It is crucial that the initial pre-purchase investigation uncover the information needed to determine an owner's obligations over time. It bears repeating: Missing issues

during due diligence does not exempt the owner from obligation. Put another way, the landowner is not exempt from post-purchase compliance just because the site investigation failed to reveal an issue.

SHELF LIFE

Lastly, when considering the major changes that the AAI brings to bear on pre-transaction due diligence, it is important that property purchasers are aware that AAI-compliant reports have a one-year shelf life. The final rule allows for information in previous Phase I reports to be used, but all data must be collected or updated to within one year of the date that the owner takes title.

In addition, interviews with past and present owners, searches for recorded environmental cleanup liens, the review of government records, a visual inspection of the facility and adjoining properties, and the declaration by the environmental professional that AAI was followed must be current to within 180 days of the property's acquisition date. Information from past reports can be used, but EPA makes it clear that considerations of the following components must be updated to reflect the current transaction: "specialized knowledge" about the property, the relationship between the current purchase price and the value of the property if it was not contaminated, and any commonly known information about the property.

This stipulation is a significant change from former practice, when it was common for a purchaser to rely on an old Phase I conducted for the property from years past and just update certain components of the old report. The EPA's language is quite clear that all 10 steps of AAI must be followed, and they must be based on current information.

COMPLIANCE

Part of the uncertainty surrounding AAI relates to just how important CERCLA liability protection is to potential property purchasers. When ASTM released its first E 1527 standard in 1993, its purpose was for individuals seeking to qualify as innocent landowners to be exempt from CERCLA liability. Over time, the industry evolved and clients became savvier about the practicality of Phase I ESAs as a tool for measuring "business environmental risk," a concept introduced in the E 1527-00 standard.

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Today, consultants report that the majority of Phase I inquiries are not conducted to qualify an owner as an innocent landowner but to protect the owner from the business risks of any environmental conditions at the property, including non-scope issues such as mold or lead-based paint. Other clients demand ASTM Phase I inquiries only in response to what lenders, attorneys or rating agencies require. This raises questions about the extent to which the market will embrace the AAI/ASTM E 1527-05 protocol. Prudent investors will make themselves aware of the new bona fide prospective purchaser and contiguous property owner protections and fully understand the additional labor required to satisfy the AAI rule—and the commensurate benefits of liability protection that go along with it—which, in certain cases, could be well worth the effort.

So how important is it to comply with the AAI rule? That depends, according to environmental attorney Barry Trilling, a partner with Wiggin and Dana in Stamford, Conn. “Parties undertaking diligence inquiries of routine commercial properties where they have no reason to anticipate site contamination and attendant liability may wish to consider ordering their environmental consultants to continue to follow the requirements of the less expensive and less onerous ASTM E1527-00 standard to screen properties for environmental issues. If, during the course of the E1527-00 examination, which would not provide a defense to CERCLA liability, the consultant discovers unanticipated liability concerns, he or she should have the flexibility to convert the examination into a broader AAI examination. In any event, prospective purchasers of commercial and industrial properties should consult with counsel as to the nature, extent, and quality of the diligence examination they will perform on subject properties.”

Property purchasers should be aware that many lenders, especially large, national lenders, are already incorporating AAI-compliant Phase I ESAs in their CRE underwriting policies. Purchasers may have no choice but to follow AAI in certain cases.

IMPACT ON REAL ESTATE TRANSACTIONS

Because it is so new, there is, understandably, considerable confusion surrounding AAI. The Phase I industry is

in a period of unprecedented transition. Also, no one is certain how Wall Street will react. Yet despite the confusion, environmental professionals are reporting that many clients will adopt the new AAI rule. “Most of our clients have adopted the new standard, or are in the process of modifying their existing scope of work to include reference to the new standard,” Mills says.

Others are waiting to see how the market reacts. Krol says her key clients—attorneys or real estate investors who are advised by attorneys—are aware of AAI and are taking it seriously. “I also have a few clients—and these are more on the financial and lender side—who are taking a wait-and-see approach,” she says.

The new law holds property owners to a higher standard of care in terms of responsibly managing contamination regardless of what was—or wasn't—found in the initial site assessment.

“Our client base basically falls into two camps,” Sirota says. “those who are aware of AAI but may not have a depth of understanding, but who still want us to conduct ESAs under 1527-05, and those who are aware but request that we (use) one of the pre-AAI ASTM guidelines, most likely for cost savings.”

“When we get a request for a Phase I, we ask, ‘00 or ‘05?’” says Pamela Pidge, a due diligence manager with URS Corp. in Fort Washington, Pa. “A lot of clients are not sure of the differences, so we explain them.”

ENVIRONMENTAL DUE DILIGENCE GOING FORWARD

It's understandable, and even predictable, that confusion is the norm as real estate investors and the consultants who advise them adjust to the new environmental regulations. Already, though, one thing *is* clear: The new law holds property owners to a higher standard of care in terms of responsibly managing contamination regardless of what was—or wasn't—found in the initial site assessment. Today, thorough environmental due diligence is more important than ever.

For more detail on the AAI rule, visit www.epa.gov.

What Environmental Professionals Say

ELIZABETH KROL: "I would always recommend thorough environmental due diligence. One of my colleagues has a client that now owns a site contaminated with PCBs because they did not perform adequate environmental due diligence prior to the acquisition. They were interested in the business that operated at the site and so it made sense for them in terms of manufacturing capacity, but they have expended well over \$1 million cleaning up a small tributary, and will also be responsible for contributing to the cleanup of a significant watershed in eastern Massachusetts as one of the primary potentially responsible parties. The *caveat emptor* or buyer beware warning is one that really should be heeded, and now with the advent of AAI, a prospective purchaser really can't claim, 'I didn't know!'"

"I think that AAI and the associated ASTM 1527-05 standard ensures a more thorough review for those who may not have thought it necessary before. In any case, a proactive, responsible buyer would want to know what concerns, if any, exist at the site. And I think that they should determine this prior to acquisition, whether they have specific development plans or not. Things change, and their plans may be revised after taking ownership, but if they haven't obtained indemnity or other appropriate negotiations/protections from the seller, it is too late and they would then be responsible for the full cost and regulatory compliance obligations. I would modify my recommendations based upon site conditions (for example, a site that already has a building onsite and would be renovated vs. vacant land or even a newly developed site). The recommendations should suit the client's risk tolerance and future plans as well as historic usage of the property."

JANE MILLS: "Prior to purchase, the developer should perform due diligence activities which include, but may not be limited to, an environmental assessment in accordance with E 1527-05, a preliminary geotechnical investigation (in locations where development is anticipated), a physical condition assessment of existing structures, and a hazardous materials survey of structures where renovation or demolition may be anticipated. Without this level of preliminary information, it would be difficult for a prospective purchaser to make an informed investment decision."

KEVIN BILLINGS: "There is a difference between an existing redevelopment and a property to be developed. Also, consider future use. There will be questions possibly of state regulators and their involvement with the redevelopment and AAI. Typically our clients have understood, or we have educated them about, the potential added construction costs and potential construction delays (and subsequent costs) of uncovering contamination during the construction phase vs. being able to underwrite the cost ahead of time and evaluating its impact on the overall project. Some clients have altered their construction design or development strategy based on the environmental conditions."

PAMELA PIDGE: "Conduct a Phase I. If we identify potential concerns, proceed with Phase II sampling activities." Pidge stresses the importance of being thorough. "In 2004, we conducted a Phase I on five acres of vacant agricultural property that was developed with a radio tower. The neighboring properties consisted of agricultural land, residences, a public park and the township public works department. Based on a review of aerial photos, topographic maps and historical fire insurance maps (none were available) plus current environmental database and township files, no evidence of environmental concerns were identified. However, in conversations with a township clerk, he recalled that the area might have been used as a dump

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in the 1960s. We recommended that our client install soil borings and collect soil samples to evaluate for environmental contamination. Arsenic exceeded cleanup criteria in two samples, lead in one. Based on this data, we then recommended delineating the impact. Long story short, this site ended up being cleaned up (soil excavation) under the direction of the EPA Superfund program to the tune of \$750,000. It is important to interview the local people!"

MARK FACKLER: "One of my first recommendations would be to consult an environmental attorney. In addition, be aware that, as a purchaser, your liability exposure is different than a lender's exposure, since (purchasers) are not afforded lender liability protections. My recommendations are typically associated with a client's specific risk tolerance. A client purchasing an existing facility may be more willing to incur a higher level of business risk since the likelihood of new discovery of contamination may be diminished. However, the findings and conclusions would be identical in both scenarios, since the liability for property and facility is the same for both."

When asked whether he had experienced resistance from property purchasers, Fackler recalled one particular case. "I worked on a project in which the buyer was so set on purchasing the property because his lease was up for renewal at the end of the week that he pushed to the bank to conduct an environmental database review instead of a Phase I ESA. The bank stated that since the loan was likely going to be securitized, they had to have a Phase I performed. The historical aerial photos indicated that the property, which was only known to be vacant land, contained a lagoon in the late 1940s and early 1950s, with a gravel roadway leading to the lagoon from a nearby metal parts manufacturer. Soil samples taken from the area noted the presence of elevated chromium, cyanide and chlorinated solvents. The lagoon was declared a solid waste management unit and is still undergoing quarterly groundwater monitoring today."

GARY SIROTA: "If a prospective purchaser is interested in making changes to the property, I would recommend a staged assessment to determine if there are any ECs or ICs and what impact they might have. Since AAI became effective, we routinely obtain more information and ask more questions in the scoping stage." When asked whether environmental due diligence turned up anything surprising for his clients, Sirota says: "I recall one particularly interesting project where we were charged with conducting a due diligence assessment of a piece of abandoned property that had been leased from a transportation company years earlier. Records indicated that the previous tenant might have conducted some low end 'recycling' on the site. The majority of the site was covered with gravel with some open ground and our experienced assessor noted a rather large area of dead vegetation off to the rear of the property. Being a suspicious sort, he collected a 'grab sample' of soil and sent it to a lab for analysis. It came back showing that the soil had high levels of PCB. A subsequent Phase II assessment indicated extensive contamination of approximately 80 percent of the site by PCB and lead. Apparently, the previous tenant was conducting unlicensed collection of electrical transformers and lead batteries in contravention of regulations. The PCB oil was disposed of in the area where the dead vegetation was observed, and the batteries and transformer cases were broken up and buried on site." Sirota says the subsequent clean-up took about a year. ■