
DEFENDING AN OIL COMPANY AGAINST LITIGATION FOR ENVIRONMENTAL CONTAMINATION (A CASE STUDY)

by Jack P. Friedman, CRE

The purpose of this case study is to demonstrate real estate consulting issues involved in the defense of a major oil company (OIL) that was sued by the owner of an adjacent neighborhood shopping center (NSC) for environmental damages. The NSC amended its theories many times, with the result that a defense was necessarily multifaceted and complex, providing the material for a unique case study. In this new millennium, real estate matters, especially litigation, will surely increase in complexity. Further, notwithstanding the need for specialization, there are many situations where knowledge in multiple disciplines is useful in providing a study of the facts that were needed for a defense.

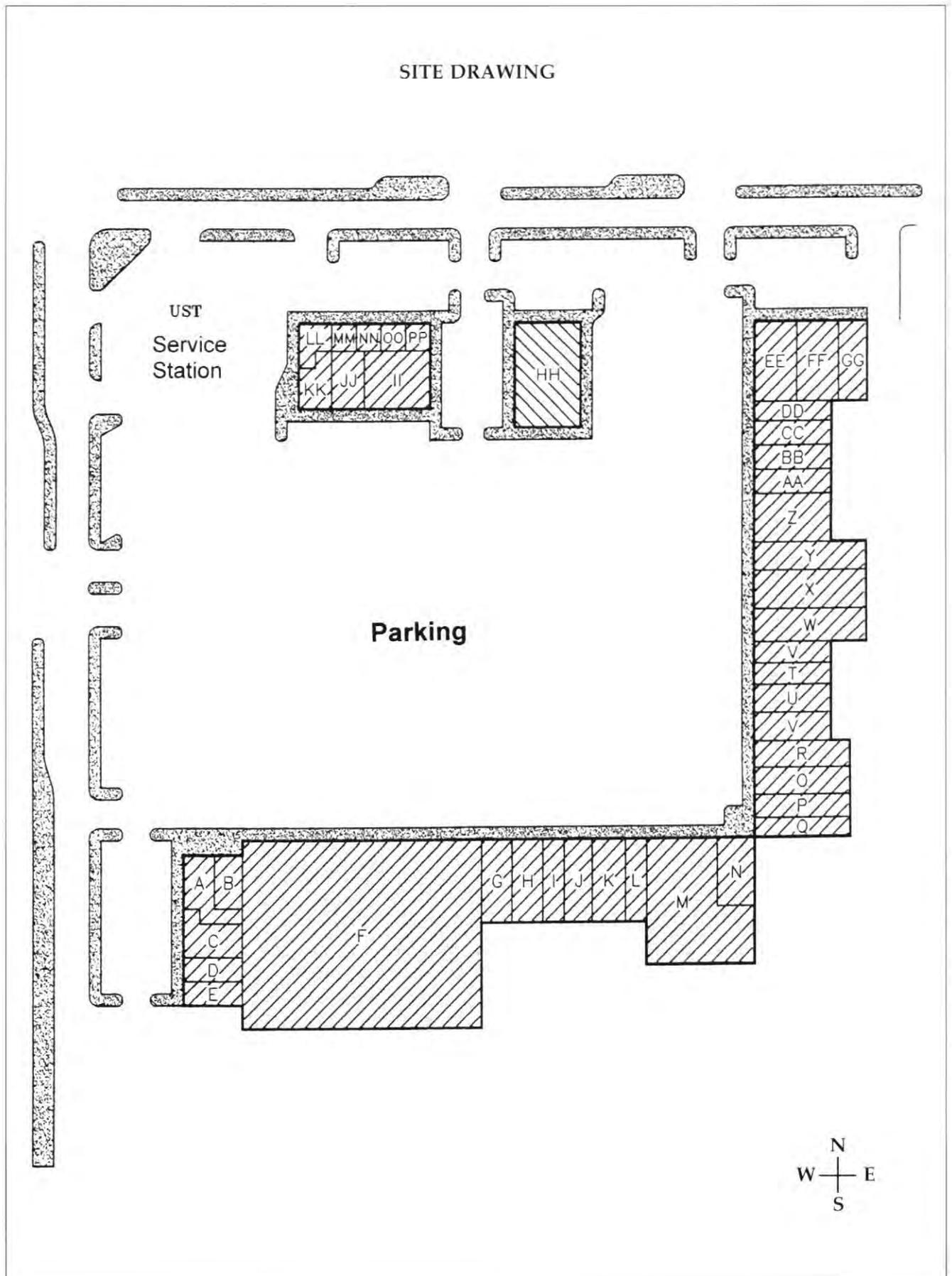
THE SITE

The event occurred in a large and fast-growing suburb of Dallas, Texas. A service station owned by OIL, located on the southeast corner of an important intersection, is surrounded by NSC (*Figure 1*). More than nine years ago, one component of an underground petroleum storage tank system experienced a leak or "release." The release was appropriately reported to the Texas Water Commission (now the Texas Natural Resources Conservation Commission or TNRCC), which added the site to its list of Leaking Petroleum Storage Tanks (LPSTs) and began the monitoring process. OIL drilled monitoring wells on its property and, with permission, on NSC's property. Periodic readings showed the extent of contamination over time.

ABOUT THE AUTHOR

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Figure 1 - NSC



THE PLAYERS

NSC

The NSC was initially built in 1977. It was purchased in 1984 by a limited partnership (syndicate) that continues as the current (2000) owner.

The NSC comprises 42 stores, anchored by a supermarket representing the dominant supermarket chain in the area. The supermarket is a 43,000 square-foot store; the total center occupies about 140,000 leasable square feet on almost 14 acres of land. In 1996 the center was refinanced at market rates and favorable terms. In that year, NSC sold a tract of land 164 feet \times 170 feet adjacent to the OIL station, to the south.

OIL

The service station, owned by a major oil company, is temporarily closed, awaiting renovation to become a convenience/fast food/self-service station. The dimensions of its site are approximately 170 feet by 170 feet = 28,900 square feet. It is on a corner.

TNRCC

The TNRCC evaluates the priority and the status of each LPST using codes. These are available on their Web site, www.tnrcc.state.tx.us.¹ Priority codes are as follows:²

- Priority 1: Emergency level.
- Priority 2: Threat to public places, threat to water supply.
- Priority 3: Groundwater is affected, public water supply is a concern.
- Priority 4: Groundwater may be affected.

The LPST status is catalogued by the TNRCC in six major areas. Within each area are several steps. The six major areas are as follows:

1. Incident report, issuance of initial directives, receipt of initial response.
2. Various report statuses of Phase II.
3. Various statuses of Phase III report, quarterly monitoring report, and remedial action plan (RAP).
4. Remedial action in progress, quarterly monitoring report overdue or received, review pending.
5. Submission of site closure application, various report statuses of final monitoring.
6. Case closed, referred to another agency or program, or inactive.

Regarding the subject site at the time of the trial, it was rated as "Priority Code 4.1, Groundwater

impaired, no apparent threats or impacts to receptors. Status Code 6P, Final concurrence pending documentation of well plugging." In other words, this site had ceased to be a problem before the trial began.

THE ACTION

Closure Letter

The TNRCC issued a "Closure Letter" on February 10, 1998. It stated, "No further corrective action will be necessary." The following criteria were stated in the closure letter:

- Currently the site is an active UST facility and predominately covered with concrete.
- A search indicated no water wells within one-half mile of the site.
- The contaminant plume appears to be confined on site and decreasing in contaminant concentrations.
- The extent of groundwater contamination has been delineated to category III target levels.
- The shallow groundwater does not appear to have a local beneficial use. Domestic water for this area is provided by a municipal water supply.
- According to the survey, no significant sensitive receptors were affected or identified at the site. Vapor calculations do not indicate a potential problem.

The NSC's Response

The NSC, which had written to the TNRCC requesting that it not close the case, urged TNRCC to reopen the case. The NSC's position was based on finding petroleum products on its site when installing a grease trap for a restaurant (a new tenant, at LL in *Figure 1*) in 1998, and earlier, in 1996, when digging into the ground to begin construction of a new building on the pad side sold earlier that year just south of the OIL station. The NSC challenged the TNRCC's findings concerning the plume. On October 28, 1999, the TNRCC answered the NSC in a letter providing its reasons for not reopening the case, justified principally by these criteria:

1. Current soil and groundwater concentrations do not exceed theoretical vapor calculations at a known point of exposure.
2. There is no history of phase-separated hydrocarbons at the [OIL] facility.
3. Although the dissolved-phase contaminant plume extends offsite, it appears to be stable. Contaminant concentrations have fluctuated in

[OIL] MW-1, however, fluctuations in contaminant concentrations over time are not necessarily abnormal. Plume stability is considered by evaluation of contaminant concentrations both inside and outside the source area. Since no significant increase outside the source area has been seen, it does not appear that the plume itself has increased in extent or should be considered unstable.

4. Soils and groundwater contaminant concentrations do not exceed Construction Worker Protective Levels or Health-Based Target Levels for a Commercial/Industrial site.
5. The site is an active commercial facility which maintains an impervious cover. Future use of the site is expected to remain the same.
6. The impacted shallow ground-water zone does not appear to have any documented local use. No water wells screened within the impacted interval were identified within 0.5 mile radius of the site.

The NSC hired environmental experts to check levels of contaminants. Those findings, their use in the trial, and the rebuttal testimony of OIL's expert are beyond the scope of this case study, which focuses on the business aspects. In short, however, OIL's experts explained and displayed to the court readings from monitoring wells that were taken and reported regularly to the TNRCC.

NSC's Changing Theories

In May 1998, an environmental company hired by NSC's attorneys provided two cost estimates. One, for further testing of soils, was approximately \$60,000; the other, for approximately \$670,000 was the estimated cost of excavating and removing soil associated with a pad site (approximately 12,000 square feet) adjacent to the OIL station (Figure 1, stores II through PP).

The \$670,000 remediation cost for the pad site was then provided to an appraisal firm, which appraised the shopping center at approximately \$12 million if clean, in an unsigned report. The appraisers extrapolated the \$670,000 amount as though it applied to the entire shopping center and provided an estimated cost to remediate all the land (changing out all the soil) of \$27 million plus the cost of rebuilding at \$18.5 million (rounded). Thus, in an unsigned appraisal report, the damages were estimated at \$45.5 million.

This damage amount was later pared down to \$3.1 million by the same appraisal firm, which then

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considered demolition and rebuilding of the 12,000-square-foot pad building only. Their cost estimate began with \$670,000 for soil removal and replacement, inflated to \$3.1 million through costs of demolition, rebuilding, releasing space, paying tenants for moving and buyouts, and for lost profits. This time the amount was not extrapolated to the entire center, and the report was signed.

The NSC also engaged, as an expert, a university professor who had co-authored several articles on the effect of contamination on property value.

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When the appraiser and academic were dropped, the plaintiff's case for damages shifted to additional past, present, and future management costs associated with monitoring the contamination, plus the cost of active remediation. In response, the defense refocused on these matters.

Although the TNRCC had issued a closure statement, NSC's law firm located an expert who discussed the need to actively bio-remediate the site. This would involve placing rods under the affected pad building. The process is to suck surface air through the ground, using powerful machinery, drawing soil vapors out to be filtered through charcoal drums. The remediation also suggested indoor monitoring of vapors using canisters placed within tenants' buildings. All of this was prepared for

execution by the expert's own company over a 30- to 48-month period.

THE DEFENSE

Because the NSC modified its charges, OIL's defense became multifaceted and complex. The author prepared a number of documents as part of the defense strategy.

Review of Articles by the Academic

The author drafted a critique of the articles prepared by the academic. Of the commercial properties studied, of particular importance was the lack of relevance to the NSC. One factor was the difference in geographical, neighborhood, and economic characteristics between the area in which these properties were located and the location of the NSC. In addition, the academic's findings for commercial property were not statistically valid, despite an assertion of same in the introduction and summary of the publication. The academic had no expertise in appraisal. Because the academic was dropped as a witness before trial, the draft critique was not finalized.

Review of Other Literature

The author made an extensive review of the literature on the subject of LPSTs with regard to property valuation. Internet searches, beginning with RealSource, provided a start. We sought help through two appraisal forums. A hard-copy bibliography³ was used to help identify the literature. Footnotes and bibliographies in articles often led to additional literature. The *Journal of Real Estate Literature* was useful in identifying existing publications. *Real Estate Issues Research Digest*, Spring 1999, offered valuable information on existing research, and the Fall/Winter 1991 issue of *Real Estate Issues* (vol. 16, no. 2), a special issue on environmental conditions in real estate, was a rich source of literature.

Draft Appraisal Review

Another preliminary work product was an unsigned draft review of the appraisal under Standard 3 of USPAP. Of special interest to this reviewer was the disparity between the operating expenses stated in the appraisal and those reported in the federal income tax returns. Of greater importance, however, was the appraiser's assumption that the pad building would require demolition. Environmental reports by NSC's experts did not assert the need for demolition. They only provided cost estimates for removing and replacing the soil. Accordingly, the draft appraisal review was critical of

the appraiser for leaping from a remediation cost estimate to extensive value diminution. This is not sanctioned by USPAP's Advisory Opinion AO-9 nor by Guide Notes 6 and 8 of the Appraisal Institute. The draft appraisal review was not finalized because the appraiser was withdrawn from the list of testifying experts.

Income and Expense Analysis

We compared the income and expenses of the NSC from its annual income tax returns for the years 1991 through 1998. Charts and graphs were prepared and used at trial to demonstrate NSC's consistently rising rent throughout the period to establish the fact that there was no economic injury to NSC from the LPST.

Charts prepared from the tax returns included exhibits showing gross rental income, all deductible expenses, deductible cash expenses, and cash flow. Rapidly rising rents meant a transformation of the investment from tax shelter status to a cash flow generator.

Current Rent Roll Analysis

Analysis of the NSC's rent rolls showed that the NSC was 94 percent occupied at the time of trial, with only two units vacant out of 42 tenant spaces. The vacancies were not near the OIL station.

Tenant File Review

In an extensive review of tenant files, NSC's leases were abstracted to show that tenants were renewing their leases at higher rents. When a vacancy occurred, the space was re-let at an increased rent.

LPST Site Analysis

A physical review of the subject's city and its neighboring city was prepared that demonstrated that the NSC's situation was not uncommon. There were more than 80 LPSTs on TNRCC's list for each city (except for the subject, none were owned by OIL). We plotted the location of each LPST on a map in preparation for demonstrating to the court how prevalent LPSTs are. A list of shopping centers in both cities was obtained from CACI. Not surprisingly, a number of other shopping centers are neighbors of LPSTs.

To answer a potential question about the effect of LPSTs on real estate activity, we identified several of the LPSTs that were in high-traffic areas. We photographed the surrounding area. Then, using dates on building permit data and ad valorem tax

data, we demonstrated the existence of new development, adjacent to LPSTs, that had occurred after the initial leak release. We also identified redevelopment (demolition and rebuilding) and numerous renovations for existing and new tenants. Not surprisingly, there were occurrences of these LPSTs at shopping centers that were "clones" of NSC (same anchor tenant, same age range, same size range).

Lender Survey

To answer the question of whether environmental contamination had an adverse effect on the ability to finance a center, we conducted a survey. This was not intended to have scientific, statistical validity; it was an effort to understand local lending practices. Of particular interest was that more than half the lenders surveyed (six out of 11) actually make loans on environmentally impaired property. When faced with an environmental impairment, nearly all lenders increase due diligence efforts by requiring at least a Phase I report. If a "no further action" letter or "closure letter" is received from the state agency, all 11 respondents said they would be inclined to approve a loan.

The NSC had been refinanced in 1996 at favorable rates and terms. However, the Phase I report prepared for the refinancing had incorrectly stated that the NSC was not on the TNRCC's list of LPSTs. At trial, NSC's attorney wanted to make an issue that, had the lender been informed, the loan would not have been made or would have been made on less favorable terms. The fact was that the property was successfully refinanced. After receipt of the closure letter, the point would be moot.

Management Survey

In 1999, NSC prepared a log of management discussions held from 1991 through 1998, with the time spent by each employee and the hourly rate for each. A six-digit amount was derived as additional management costs.

To answer the question of whether an additional management fee is charged for managing a contaminated property, we conducted another survey, this one of property managers in the Dallas/Fort Worth area. Interesting findings from this survey were that an additional management fee is justified for property needing remediation, with fees based on three percent to five percent of the money spent for remediation. When remediation is not required, no additional management fee is due. In addition, NSC's general partner/manager

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charged its limited partners a routine management fee of six percent of the gross rent. This gross rent includes tenant reimbursement in rent. Our study, plus other sources, indicated that four percent of gross rent is the competitive rate for this type of property, indicating that NSC's management charges are more than sufficient.

Ad Valorem Tax Study

The *Texas Property Tax Code* provides relief from ad valorem taxes for environmental impairment (Section 23.14) or in cases of decreased value (Section 22.03). Through tax data, we found that NSC's owners had not challenged their assessment for the current year, and there was nothing to indicate that they had ever appealed the assessment for an environmental reason.

Appraisal

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Business Judgment

If active remediation were to take place, would stigma result? NSC's bio-remediation expert had prescribed a plan for soil treatment as one that would not make too much noise. Still, it would involve running heavy equipment and placing drums or canisters inside and outside the pad building to monitor soil vapors for at least 30 months. Certainly this would not bring business to NSC and could create a stigma (negative public perception). In addition, the TNRCC did not recommend active bio-remediation and might not approve it because of the soil type. From a business standpoint, then, these activities could create stigma through their negative visual appearance.

SUMMARY OF CONSULTING CHALLENGES

As to real estate consulting challenges, the activities and skills required include:

- Intense understanding of the literature
- Objective review of appraisal reports
- Survey instrument preparation and survey techniques
- Ability to read and interpret federal income tax returns
- Ability to secure publicly available data for ad valorem taxes and building permits
- Graphic presentation of financial data
- Tenant file review, lease abstracting
- Consideration of management issues

CONCLUSION

In summary, it took many skills and a great deal of effort and coordination to present the facts accurately for the jury's consideration. Data provided to the jury from an extensive and intensive multifaceted study proved to be effective, and the jury found for OIL_{REI}.

NOTES

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REFERENCES

1. The TNRCC has informative data and general publications available on its Web site.
2. *Priority levels 1.1 to 1.7:* These range from "explosive levels, or concentrations of vapors that could cause acute health effects" (1.1) to those that are much lower but still could have a health effect or safety concern (1.7). These levels require emergency action.
Priority levels 2.1 to 2.7: These range from contaminated soils or water that are "exposed and unsecured from public access" and located within 500 feet of "dwellings, playgrounds, parks, day care centers, schools, or similar use facilities" (2.1) to "a public or domestic water supply well that produces from a groundwater zone which is not affected or threatened, located within the known extent of contamination" (2.7).
Priority levels 3.1 to 3.5: Priority 3 sites range from sites where groundwater is affected within 0.25 and 0.5 miles of a public or domestic water supply well (3.1) to the possibility of affecting a non-community or non-domestic water supply (3.4) or a designated aquifer (3.5).
Priority level 4.1: Groundwater is affected.
Priority level 4.2: Groundwater is not affected.
3. Compliments of Bill Mundy, CRE.