The Property Line Podcast – Digging Into Environmental Due Diligence

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Welcome to The Property Line, a commercial real estate podcast brought to you by Seyfarth Shaw's Real Estate department. The Property Line is a brief discussion of current market trends, bringing you insights from our acclaimed national team of real estate attorneys. Each episode focuses on a key takeaway for the busy real estate professional. Now, on to this week's discussion.

James: Hello, and welcome back to The Property Line. My name is James O'Brien, and my co-host is Eric Greenberg. We're both partners in Seyfarth Shaw's real estate practice, and we're joined today by Jon Bull, a fellow real estate partner and recent addition to our team. Jon is based in Dallas, where his practice focuses on counseling clients concerning the legal risks of environmental issues in real estate and corporate transactions. Welcome, Jon. Thanks for joining us.

Jon: Thanks so much, James. Appreciate being here.

James: It's great to have you and great to have you at the firm. I know it's been a few months, but it's nice to have you here and have an environmental expert on the team. So Jon is here to discuss the basics of due diligence — environmental due diligence — in real estate and corporate transactions, with a particular focus on Phase I environmental site assessments. So Jon, to start, can you provide us with a brief overview of environmental diligence and why it's important in real estate transactions?

Jon: Sure. Thanks so much, James. Look, our federal and state environmental laws can be sources of liability to owners and operators of real property. This can include liabilities associated with a company's operations on the property, such as compliance with permits or requirements for managing hazardous waste. These liabilities also include strict ownership-based liability associated with pollution conditions — hazardous substances that are contaminating environmental media such as soil, sediment, soil vapor, groundwater, and surface water.

Environmental diligence typically is one of several areas of legal review that a buyer performs when they are acquiring a company and/or agricultural, commercial, or industrial assets, in order to identify these potential environmental liabilities so that they can be addressed in the context of the transaction. This process typically involves understanding the operational history of properties to be acquired, reviewing operating records, permits, and compliance-related information. It also involves bringing in an environmental consultant to perform a Phase I environmental site assessment. The purpose of the Phase I is to evaluate the potential for hazardous substance contamination of the property and potentially whether further environmental assessment may be needed based on the results of the Phase I.

Eric: Jon, you mentioned the Phase I, the Phase I environmental site assessment, is a common element of environmental diligence. Can you dig a little deeper — tell us what these reports cover and how they can benefit a purchaser?

Jon: Absolutely. Thanks, Eric. The use of Phase Is started back in the 1980s following passage of CERCLA, which is our federal Superfund law. CERCLA imposed this strict, joint and several ownership-based liability for the cleanup and cost of cleanup of hazardous substances contamination at an owned property. This liability was subject only to a third-party or an innocent owner defense. Even in the early days of CERCLA, Phase I ESAs were developed and used in part to support a potential innocent owner defense.

Later, to encourage redevelopment of contaminated properties, CERCLA amendments were passed in 2002 that codified additional exemptions and defenses to this strict landowner-based liability. These include an innocent owner defense, which is available to a party that purchased the property without knowledge of contamination; a bona fide prospective purchaser defense, which is available to a purchaser who was aware of contamination when they purchased it; and a contiguous property owner defense, which is available to an owner whose property has been contaminated by an offsite release, such as groundwater contamination that flows onto or underneath unowned property.

James: Got it. So two follow-up questions, Jon. One thing for our audience that aren't attorneys — when you say "strict landowner-based liabilities," do you mean basically that it doesn't matter if you've been at fault or been negligent, you're just liable for the cleanup if you own the property?

Jon: That's exactly right, James. Under CERCLA and many state analogs, the current owner of a property can have liability for environmental cleanup or cost of environmental cleanup. This is without regard to the timing of the contamination or fault. So it is a strict ownership-based liability.

James: Right. And part of the diligence by the buyer is to try to protect itself from that liability by taking the steps that are required, including getting a Phase I. When you say a person is an innocent owner — maybe they did a Phase I, nothing came up, they purchased the property, it turns out there was something there, they didn't know about it — in what ways does the statute protect somebody who did this diligence, discovered there was contamination, and proceeded? That seemed to be the bona fide prospective purchaser defense you mentioned.

Jon: Right. This bona fide prospective purchaser defense is significant. In order to enjoy these defenses — really, all three of these defenses — it requires performing environmental diligence, what's called "all appropriate inquiry," prior to purchasing. If a party is aware of contamination and proceeds with the purchase as an owner, then it has to satisfy what are called continuing obligations and reasonable steps with respect to the contamination.

These are things — and it can vary from case to case — it may include reporting contamination to a regulatory agency, allowing access to the property for a responsible party to come on and perform cleanup of the contamination, abiding by any land use restrictions that are associated with the contamination. So a host of essentially

cooperative steps with respect to amelioration of the conditions and preventing any further releases of contamination.

James: But they wouldn't be themselves liable?

Jon: Right. They wouldn't be liable under these strict liability statutes, provided that they performed appropriate inquiry, that they did not contribute to the contamination, that they took steps to essentially ameliorate the contamination, and cooperated with any parties or regulatory agencies that are addressing the contamination.

James: I guess that would just be a separate determination by the regulatory authority as to who actually the responsible party was.

Jon: It always is, and it's a tricky business for sure.

Eric: Well, okay. I know you were going to also explain to us sort of the basics of what a Phase I actually is.

Jon: Right. So the Phase I is an ASTM standardized assessment and reporting practice. It's performed by a qualified environmental professional, which can be a consulting engineer, a geologist, or an environmental scientist. The goal of the Phase I is to identify potential hazardous substance contamination affecting the property.

When we talk about hazardous substances in this context, it's very broadly defined. It includes substances listed or regulated as hazardous under environmental laws. For example, it could be chlorinated solvents, pesticides, hazardous metals, as well as petroleum and petroleum products.

The key elements of the Phase I assessment include an evaluation of historical and current operations at the property, interviews with site owners and operators, a site inspection to assess hazardous substances that are used, stored, or disposed of at the property, and observations of adjoining properties. The practice also includes a review of the results of a wide array of environmental regulatory databases for information concerning the target property and properties in the surrounding area.

The subject matter of these databases covers categories of regulatory information concerning properties which have operations or site conditions that require environmental regulatory interaction. For example, these include databases of properties with underground storage tanks, landfills, properties where environmental releases have been reported, properties in a state or federal cleanup program, Superfund sites, Department of Defense sites, and sites with federal or state hazardous waste storage, management, treatment, or disposal permits.

Importantly, the Phase Is do not involve sampling or testing of environmental media such as soil, groundwater, soil vapor, or other media. Rather, the Phase I identifies potential hazardous substance conditions, which are termed "recognized environmental conditions," or commonly called RECs. Any additional assessment that includes

sampling or testing may be warranted, and that's under a separate practice called a Phase II assessment.

Eric: Right. So Phase Is are effectively like an inspection of the property and a record search, but not any real investigation — not any invasive investigations.

Jon: That's exactly right.

Eric: So what are some basic practice tips for the use of Phase Is? If you were advising a client who was purchasing a property, what are the tips you'd have for them?

Jon: Great question. So Phase Is, I would say, first, they're routinely required by lenders for financing. Depending on the results, you should be prepared to also perform Phase II work, which may be required by lenders based on the results of the Phase I.

You should assure that the performance of the Phase I is addressed early in the deal. Make sure that as a purchaser, you have the ability to perform your environmental diligence, you have enough time to do it, and if possible, that you're able to perform Phase II testing if that's warranted based on the results of the Phase I. So plan early. Allow time and budget for Phase Is at each commercial, agricultural, or industrial property that's being acquired in a deal.

Don't rely on old Phase I reports or reports that are performed for other parties. This is an important part. If a prior report prepared for a buyer is over a year old, or certain elements are over 180 days old as of the closing date of the transaction, you need to perform an update or a new report in order to use that Phase I report as a basis to establish these landowner defenses.

Eric: Jon, on that issue — because this comes up a lot for deals that have been going on for a while or there's new buyers — is the age issue, the length of time, a statutory requirement? Is it a best practice? And what about reliance letters for use of a recent report issued to another party?

Jon: Those are great questions, Eric. The deadlines with respect to the age of the report or the age of certain elements of the report — these are in the ASTM best practice. The ASTM best practice in turn is incorporated in the EPA's regulations under CERCLA and its regulatory definition of all appropriate inquiry. So while it's not necessarily in the statute itself, these deadlines are important deadlines and are incorporated by reference in the regulations.

With respect to reliance letters, we run across this commonly, and reliance letters can be effective. What these are, essentially: each Phase I report will include language that only allows reliance on the client of the consultant. In order for another party to be able to rely on the Phase I and use it for purposes of establishing all appropriate inquiry, a reliance letter from the consultant can be used.

Eric: Well, thank you. I know you had some other practice tips. Why don't we continue with those?

Jon: Yes. One is: keep your Phase I reports privilege-eligible. In this regard, buyers may consider having their attorney hire the Phase I consultant and order the Phase I services on their behalf. This practice can protect the Phase I report under an attorney-client privilege, as the report is critical for the attorney's ability to advise the buyer — its client — of legal risk associated with the transaction. Also, arrange with a Phase I consultant to provide verbal deliverables to the buyer's attorney before issuance of a draft or a final Phase I report.

Eric: Right. So it seems like both the attorney-privilege-eligible concept and the verbal delivery — to sort of find out what's in there — are ways of keeping that knowledge from being public, initially trying to keep it protected. Looking at it from another perspective: so the buyer doesn't want this information necessarily to get out until he's satisfied with what's in there and doesn't want it to be discoverable necessarily in a lawsuit. But what about a seller? If the seller knows that the buyer is doing environmental due diligence and knows that he has strict liability for environmental issues at its property, does it want to know what's in the Phase I report or in a subsequent Phase II report? Or can it have willful ignorance that protects it and keeps it as an innocent owner?

Jon: Certainly. From a seller's perspective, it really can vary based on the deal and the types of properties that are involved. But it's not uncommon that a seller will provide an opportunity for the purchaser to perform a Phase I or, if necessary, a Phase II, and to use that information as a basis to proceed with the deal or not, without providing the seller with a copy of the Phase I.

The risk for a seller really is that if they get a Phase I report that the buyer performs and it identifies a REC, if the deal does not go through, then the seller will have in its possession a Phase I report that identifies this condition. Those will need to be typically disclosed to future purchasers in the course of their diligence. So it's not uncommon that a seller will essentially try to insulate itself from the results of a Phase I.

Alternatively, if the Phase I report identifies issues and they're significant, that's a point where the parties need to get together and decide how to address those issues in the deal context. Part of the purpose of doing the due diligence is to identify environmental risk and to address it in the deal context. So it's a case-by-case basis.

Eric: And I guess even if you don't take possession of the report as a seller, but then it recommends Phase II testing and you allow that, you're almost tacitly acknowledging that there were issues — even if you didn't obtain the report — because you're allowing the additional investigation. But yeah, it's an interesting issue that comes up from time to time. I know you had a couple of final best practices points before we wrapped up.

Jon: Yeah. Just in general, Phase I and Phase II environmental site assessments — they're important aspects to your diligence. Use these, as a buyer and really as a seller, as ways to quantify and allocate environmental risk and cleanup liability risk between a seller and a buyer in the transaction documents.

And lastly, in the leasing context, Phase I reports and, if warranted, Phase II reports can be important for an owner as well as for a lessee to establish baseline conditions at the start of a lease. This is especially helpful when leasing a property for commercial or industrial use that involves hazardous substances. So not only in a purchase context, but in a property leasing context, these reports can be very useful.

Eric: Right. Often a tenant will disclaim any liability for hazardous substances that existed at the outset of the commencement of the lease. So it would be good to actually know what those were. But anyway, we're at the end of our time, so we will wrap it up here. Jon, thanks for joining us today and for sharing your insights.

Jon: Thanks so much. Excited to be here and appreciate it very much.

James: Thanks, Jon. A special thanks to our listeners as well. Thanks to them for tuning in, and please keep an eye out for future episodes. Until then, be well.

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