

## The Role of Environmental Due Diligence in Property Transactions

A Phase 1 ESA can protect site owners, developers and others from CERCLA liability.

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*A commercial developer purchases a large parking lot for the purpose of building an apartment complex. Years ago, the seller had two buildings on the property, which he leased to two businessmen operating a machine shop and a plating facility in the buildings. Due to personal reasons and changes in the business climate, the seller chose not to renew the leases. Subsequently, he demolished the buildings and converted the property to a parking lot.*

*Aware that the machine shop and plating facility might have impacted the site, the commercial developer puts a clause in the purchase contract indemnifying himself from any potential environmental liability that might arise from past uses of the site.*

*As the new apartment complex becomes operational, however, some of the tenants notice the appearance of greenish and dark brown discoloration in some areas of exposed soil. Analysis reveals elevated levels of chromium, nickel and hydrocarbon, materials known to present a threat to human health and the environment.*

*A lawsuit by the tenants results in a judgment holding the developer responsible for the site cleanup. Although the developer appeals the decision based on the claim that only the parties causing the contamination can be found liable for the site cleanup, the court rejects the appeal and upholds the verdict.*

### **Regulatory background**

The above story conveys some important lessons about property transactions. The federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), also known as Superfund, established sweeping environmental, financial and legal provisions to help clean up contaminated sites.

According to the U.S. Environmental Protection Agency (EPA), CERCLA authorizes two kinds of response actions: 1) short-term removals where actions may be taken to address releases or threatened releases requiring prompt response; 2) long-term remedial response actions that permanently and significantly reduce the dangers associated with releases or threats of releases of hazardous substances that are serious, but not immediately life threatening. These actions can be conducted only at sites listed on EPA's National Priorities List (NPL).

CERCLA's hazardous-substance category encompasses a large number of chemicals having toxic, corrosive, flammable and other harmful properties endangering human health and the environment. Since 1980, the year CERCLA was enacted, several billion dollars have been spent nationwide to clean up contaminated sites. Cleanup costs, even for a relatively mildly contaminated site,

can amount to several million dollars.

CERCLA liability targets the following potentially responsible parties (PRPs):

- Current owners and operators.
- Any former owners and operators of the site who were present at the time of contamination and afterward.
- Waste generators who arranged for waste disposal.
- Waste transporters.
- Other parties connected to the property.

In the preceding story, PRPs would include the developer (buyer), the lending institution, the construction company that built the apartment complex, the previous owner (seller), the owners of the machine shop and plating facility, the transporter of the contaminated soil, the title company and the real estate agents.

Liability under CERCLA is defined as strict, joint and several. Strict liability assigns liability based on the established link between the PRP and the contaminated property -- without the need to *prove* the PRP actually caused the contamination. Joint and several liability means that each of the PRPs can be made financially liable for the total site cleanup.

In our example, the judge's decision was based primarily on the fact that the current owner also is the developer. To recover the cleanup cost, the developer could sue the previous owner, citing the "hold harmless" provision in the purchase contract.

However, the hold harmless provision likely would fail to protect the developer in court because under CERCLA, environmental responsibility cannot be delegated by contractual agreement between a seller and buyer. In turn, though, the previous owner might attempt to locate and sue the owners of the machine shop and plating facility that originally caused the contamination.

If the developer declared bankruptcy and the lending institution took ownership of the property, the lending institution would be held responsible for the cleanup cost. Based on lender's liability, the lending institution would be required to solve the borrower's environmental problem. The cost of cleanup could easily exceed the borrower's funds, thus adversely impacting the lender's balance sheet.

The moral of the story? Because the current owner failed to investigate the environmental status of the property *prior to transaction*, he/she ended up with liability for the site cleanup.

### **Innocent purchaser and due diligence**

What protection does a buyer have from environmental liability? The innocent purchaser (or landowner) defense, added to CERCLA in 1986, minimizes the purchaser's legal exposure associated with environmental liability. This means that at the time of the acquisition, the buyer must conduct all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial and customary practice. Carrying out this inquiry is called due diligence.

The innocent purchaser defense based on due diligence may be invoked in the

following situations:

- At the time the property was acquired the purchaser did not know or had no reason to know that the site was impacted by a hazardous substance.
- The site was impacted by a third party.
- The third party is not related contractually to the purchaser.

In due diligence, an environmental site assessment (ESA) known as a Phase I ESA must be conducted to identify recognized environmental conditions. Recognized environmental conditions include the presence or likely presence of hazardous substances and petroleum products at the site, indicating past or present release, or the potential of a future release.

An owner might claim third party contamination if someone intruded upon the property and caused the site's contamination. To be successful, the owner would need to demonstrate that the property was well protected by physical and administrative means. A flimsy gate, an ill-maintained fence, dim or missing lights, or lack of guards would significantly decrease the chances for a successful third-party claim.

Phase I ESA methodologies have evolved over time, and have culminated in the now widely practiced American Society for Testing Materials guidelines (ASTM E-1527). In addition, ASTM E-1528 guidelines address what is known as a transaction screen process, which is a simplified version of ASTM E-1527. Opting for the transaction screen process is a judgment call that should only be used when a benign environmental situation is anticipated and thus the due diligence process is not expected to be compromised.

ASTM published a revised version of the E-1527 guidelines in mid-2000. Included in this version are revised definitions of terms such as "business environment risk" and "historical recognized environmental conditions," along with a revised report format and guidance on selecting a qualified Phase I investigator. Further information is available at [www.astm.org](http://www.astm.org).

### **The due diligence process**

**Records review.** The records review is intended to identify records pertaining to recognized environmental conditions at a site. Records are obtained from reasonably ascertainable and standard sources that are publicly available and allow for a practical review of the information. In other words, one is not required to conduct an all-exhaustive research to ferret out records from esoteric sources.

In practice, the environmental record search is extended beyond the boundary of the subject property to a minimum search distance -- typically one to two miles -- to identify facilities that might have contaminated the subject site. Standard sources for environmental record searches include federal, state and local databases containing information on past spills, releases, cleanups and violations. The record search also includes a title search for past ownership of the site, building department records and historic aerial photos, as well as topographic and fire insurance maps.

**Site reconnaissance.** This includes visual and physical observation of the site for recognized environmental conditions at the time of the site visit. Often these conditions can be subtle and not easily noticed -- e.g., discolored soil, a pipe sticking out of the ground. For this reason, an experienced person should conduct

the site reconnaissance. This individual must document all observations, which includes taking field notes and photos.

Typical items to observe at a site include:

- Overall layout: flat, rolling, paved, exposed soil, direction of drainage, etc.
- Current use: vacant lot, presence of buildings, manufacturing facility, etc.
- Indications of past use: abandoned buildings, storage tanks, railroad tracks, etc.
- Adjacent properties: types of industry, roads, residential areas, etc.
- Water and power supplies.
- Storage tanks, drums, containers and cans: in use or abandoned?
- Vegetation: normal or stressed?
- Stained soil, sheen on water, foul smell.
- Presence of waste: hazardous, petroleum, household, etc.
- Wells: water, oil, gas, etc.
- Pits, ponds and lagoons.

It is *not* in the scope of the site reconnaissance either to collect or submit for analysis samples of soil, water or air, or to perform any other invasive investigation such as drilling or conducting asbestos or radon surveys.

**Interviews.** Interviews with current and past owners of the site and with agency representatives can provide important additional site information. A reasonable effort must be made to locate these persons, and the interview must be documented in writing.

The interviewer is required to ask pertinent questions regarding the property, but the interviewee has no obligation to respond. Areas of questioning might include a description of operations, handling/storage of chemicals, date of removal of underground storage tanks, waste handling practices, and history of environmental violations and penalties.

**Preparing the ESA report.** Results of the Phase I ESA are consolidated in a report. In addition to the narrative text, the report must contain all support documentation such as copies of record searches, maps and photos.

The hallmark of a properly conducted Phase I ESA is its recommendations. In some situations, for example, the report reveals the need for a more in-depth study of the site. Visual observation of unlabeled, rusty drums, pipe sticking out of the ground, stressed vegetation, or an oily sheen on water surfaces all supports the need for further investigation, known as a Phase II study.

What to expect from due diligence

It is important to understand that ASTM guidelines are indeed only guidelines -- the scope of the Phase I inquiry should reflect site specificity. Also, negative findings of a due diligence process do not guarantee a clean bill of health for the site. That would assume a risk-free world, which is never the case. However, by conducting a Phase I ESA, a buyer can minimize the chance of purchasing an environmentally tainted property.

To use an analogy, due diligence is reminiscent of a physical at the doctor's office.

The scope of the checkup typically includes reviewing past health history, asking questions about current health status and conducting a limited examination. The checkup is not an exhaustive investigation, but its results should reveal the need for any further investigation into suspected health problems. But, even if done by a qualified and competent doctor, negative results only minimize the likelihood -- but do not eliminate the possibility -- of the existence of a medical problem.

Finally, a seller has an obligation to disclose to the buyer any environmental problems associated with the site. A contaminated property certainly raises a red flag, yet it still can offer an attractive buying opportunity. Also important: A buyer who opts for cleaning up the site should negotiate a discounted selling price based on the cost of this cleanup.

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#### National Priorities List Status as of Mid-2000

- Number of sites on final National Priorities List (NPL): 1238
- Number of sites remaining on proposed NPL: 57
- Total number of final and proposed sites: 1295
- Number of sites on construction completion list: 689
- Number of sites deleted from final NPL: 213
- Number of sites with partial deletions: 19

Source: EPA

#### National Priorities List Actions by Fiscal Year\*

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Proposed sites	30	52	36	9	27	20	34	37	40
Finalized sites	0	33	43	31	13	18	17	43	39
Deleted sites	2	12	13	25	34	32	20	23	18
Construction Completions	88	68	61	68	64	88	87	85	28