
Doing Environmental Due Diligence

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Knowledgeable real estate professionals understand that environmental contamination not only affects the value of property, but also may create liability that far exceeds that value. They may understand too that the federal Superfund statute is the primary source of that liability, imposing on landowners responsibility for investigating and remediating contamination on their property irrespective of whether they caused it. As a result of that understanding, knowledgeable real estate professionals know to obtain a "Phase 1" environmental report as part of their pre-acquisition due diligence. EPA recently promulgated its "All Appropriate Inquiries ("AAI")" rules that will change how Phase 1s are performed and the type of information they produce. But the question remains whether and to what extent AAI should be undertaken.

The concept of AAI arose from the so-called innocent purchaser defense of Superfund. As enacted in 1980, Superfund imposed liability on so-called potentially responsible parties, which includes present owners and operators of contaminated properties, subject to certain defenses. The most pertinent defense for landowners was the third party defense, which is available if the defendant can show, among other things, that the contamination was solely attributable to the act or omission of a third party and that the act or omission did not occur in connection with a contract with that defendant. The concept of "contractual nexus," however, was often ignored by courts.

To be sure "innocent purchasers" were protected, Congress amended Superfund to provide a defense to a present landowner, even if there were a contractual nexus, provided the landowner could show, among other things, that it was innocent — that it did not know and had no reason to know the contamination was

present. The prerequisite of "had no reason to know" was embodied in the concept of AAI and, when Congress again amended Superfund in 2002, it provided guidance to EPA to flesh out by regulation what the concept meant and added two new transaction-related defenses — bona fide prospective purchaser and contiguous landowner — that also required AAI.

EPA's new rule becomes effective November 1, 2006. In the meantime, prospective purchasers may use either the new rule or the current practice. Under current practice, a so-called ASTM Phase 1 (E1527-00), comprising a checklist of pertinent inquiries, is satisfactory; the new rule, embodied in a new ASTM standard (E1527-05), injects a significant degree of subjectivity on the part of the environmental professional conducting AAI.

Key elements of the new rule include the following minimum requirements:

- the investigation be supervised by a qualified environmental professional;
- specialized knowledge of the party commissioning the investigation be documented, *e.g.*, as to the relationship of purchase price to value of property if not contaminated, commonly known or reasonably ascertainable information about the property, and the degree of obviousness of the presence of the contamination;
- data gaps and information reviewed to address those gaps be identified, and comments be provided on the significance of those gaps to the environmental professional's ability to identify conditions indicative of releases or threat of releases;

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- shelf life and updates requirements be met, *i.e.*, the investigation be conducted no later than one year prior to taking title and certain aspects of it, such as onsite inspection, no later than 180 days prior to that date.

The changes effected by the new rule raise a number of practical concerns. The lack of a prescribed checklist and the requirement for a data gap evaluation create uncertainty as to whether a particular assessment has met the performance-based standard. The "freshness" requirement may affect the timing and logistics of transactions involving multiple properties and therefore the feasibility of conducting AAI. The interview requirement not only creates additional uncertainties regarding whether AAI has been performed, but also raises issues with regard to the ability of the parties to a transaction to maintain confidentiality. But beyond these concerns, there are significant reasons why purchasers should not blindly conduct AAI and instead should consider each particular transaction in light of their own risk management objectives.

EPA's AAI Rule identifies the procedures a prospective purchaser must follow to satisfy only one of the prerequisites to taking advantage of certain transaction-related defenses (innocent landowner, bona fide prospective purchaser, and contiguous landowner) under Superfund. To prevail in a Superfund enforcement action, the purchaser also must show compliance with certain continuing obligations, including taking reasonable steps with respect to hazardous substances on the property to stop and prevent releases and prevent and limit exposure. So, to take advantage of the transaction-related defenses, the defendant may end up having to spend a lot of money to address the release.

Another significant concern with the AAI prerequisite in particular and the transaction-related defenses in general is that

they become relevant only with respect to Superfund liability; they do not protect against liability under other federal laws, including other federal environmental laws, state environmental laws, or the common law such as trespass, negligence, and nuisance. Moreover, although ASTM investigations do address petroleum-related contamination, they do not provide protection against liability relating to that type of contamination, because petroleum is not within the universe of hazardous substances addressed by Superfund. Moreover, because the transaction-related defenses apply only to purchases of land, they provide no protection in stock acquisitions or mergers.

Not only do the defenses that AAI makes available provide limited protection, the investigation that AAI contemplates does not address numerous concerns that should be addressed as part of a meaningful environmental due diligence. Additionally, because AAI is focused on assets acquisitions, it does not address concerns relating to stock acquisitions and other transactions with the potential for successor liability, such as liabilities associated with formerly owned or operated properties and offsite disposal. For these reasons, a sophisticated purchaser in a transaction involving real estate will look at the unique circumstances of their particular transaction to insure all potential significant environmental concerns are addressed and will not focus only on AAI.

If there is the potential for successor liability--as in a merger, the prudent purchaser will consider past as well as present liabilities, and offsite as well as onsite liabilities. For properties with ongoing operations, the prudent purchaser also will want to conduct a compliance assessment, to be sure the facilities are in compliance with pertinent requirements, including having all necessary permits. For properties that are to be developed, the purchaser will want to identify pertinent land use

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restrictions, including, for example, those relating to endangered species, wetlands, protected watersheds and aquifers, and flood plains, to determine how those might affect future development.

Where the properties contain buildings, the prudent purchaser will want to focus on lead paint, lead in potable water, PCBs, and asbestos, in addition to hazardous substances and petroleum-related contamination. The prudent purchaser of properties containing buildings also will want to look at indoor air quality, including the potential for mold.

In sum, especially for pure real estate transactions, purchasers will want to consider AAI. All things being equal, the various

transaction-related defenses of Superfund are worth taking advantage of. But the availability of those defenses should be weighed against the associated burdens, such as issues relating to timing, confidentiality, cost, and the requirement to stop releases, and the limitations of AAI should be taken into account. Sophisticated parties to real estate transactions, understanding the relevance of AAI and the innocent purchaser and other transaction-related defenses, will not blindly apply AAI, but instead will design and implement a program to generate and process pertinent data that helps identify all pertinent environmental concerns. ■

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