Environmental Due Diligence in Commercial Real Estate Transactions

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I. Introduction

All commercial real estate transactions involve some level of environmental risk, regardless of whether the property being transferred was formerly used for industrial, commercial, agricultural, or residential purposes. Accordingly, it is important for a buyer to consider conducting some level of environmental due diligence prior to purchasing real property. Environmental due diligence will allow the buyer to identify and quantify the environmental issues associated with the property.

II. Liability Arising from Ownership of Real Estate

Environmental liability in purchasing real property may arise from several different federal or state statutes. In regard to real estate transactions, there are two federal statutes which create the greatest potential for environmental liability. These two federal statutes are the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, commonly known as "Superfund" or "CERCLA"[1], and the Resource Conservation and Recovery Act of 1976, commonly known as "RCRA"[2]. While liability under these two statutes is triggered in different ways, both statutes govern the cleanup of hazardous materials that have been released into the environment. This article focuses only on CERCLA liability; however, it is important for a buyer to understand that acquiring a contaminated property in the United States may also present risks and liabilities under other federal and state statutes and common law.

A. CERCLA Liability

Potential liability under the federal statute, CERCLA, has been one of the major driving forces behind buyers conducting environmental due diligence in real estate transactions.[3] Under CERCLA, the U.S. Environmental Protection Agency ("EPA") or another private party may sue any current or past owner or operator of a contaminated property for costs associated with cleanup.[4] In addition to federal CERCLA law, many states have their own version of "CERCLA" that have been modeled after or are similar to CERCLA.[5]

CERCLA makes current owners of property responsible for paying for cleanup of hazardous substances on their property.[6] Under CERCLA, a property owner is liable for cleaning their property if hazardous substances are found even if they did not cause or contribute to the contamination.[7] In many cases, a property owner who purchased property with pre-existing contamination is liable for the cleanup costs. Further, CERCLA liability is joint and several, meaning any liable party may be required to clean up all contamination at a property, even if that party only caused a small amount of the total contamination.[8]

There are few statutory protections or defenses absolving purchasers of property from liability for hazardous cleanups under CERCLA. Three of these defenses include the bona fide prospective purchaser ("BFPP") defense[9], the contiguous property owner defense[10], and the innocent landowner defense[11]. These three defenses all share one common element – a buyer must conduct "all appropriate inquiries . . . into the previous ownership and uses of the facility in accordance with generally accepted good commercial and customary standards and practices."[12]

The 2002 Small Business Liability Relief and Brownfields Revitalization Act to CERCLA required EPA to promulgate regulations establishing standards and practices for conducting all appropriate inquiries ("AAI").[13] The AAI rule provides that a Phase I Environmental Site Assessment ("ESA") prepared in accordance with ASTM International ("ASTM") Standard E1527-13 ("Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process") can be used to satisfy the statutory requirements for conducting AAI.[14] Accordingly, for most buyers, satisfying the AAI rule means performing a Phase I ESA that is consistent with the ASTM Standard E1527-13.

A Phase I ESA is an investigation into past and current ownership and uses of a property to assess the potential existence of hazardous substances or petroleum contamination on, in, or at a property.[15] A Phase I ESA investigation is non-intrusive and does not include any sampling or testing of the property. A Phase I ESA must be performed by an "environmental professional" and generally involves a review of publicly available records; a site visit; interviews of owners, occupants, and local government officials; and a report providing the results of the investigation and the environmental professional's opinion as to whether there is particular evidence of contamination, or reason to believe, that the property is contaminated. Ultimately, the purpose of the Phase I ESA is to identify recognized environmental conditions ("RECs") that may affect the property or trigger liability for the buyer and determine whether further due diligence in regard to the RECs is appropriate.[16]

A Phase I ESA meeting the AAI requirements is only valid for one year.[17] Further, certain components of the Phase I ESA must be conducted or updated within 180 days prior to the acquisition of property.[18] These Phase I ESA components include interviews with owners, operators, and occupants; searches for environmental cleanup liens; federal, tribal, state, and local government records review; visual inspection of the property and adjoining properties; and the declaration of the environmental professional who conducted the assessment or update.[19]

B. The Bona Fide Prospective Purchaser Defense

A buyer who meets the legal criteria of a "Bona Fide Prospective Purchaser" pursuant to 42 U.S.C. § 9601 (40), and the equivalent defense under state environmental statutes, if applicable, qualifies for protection from CERCLA liability for pre-closing contamination even if they knew that a property was contaminated at the time of purchase.[20] In order to establish a BFPP defense, parties must conduct certain steps both prior to and after the purchase of property. Most importantly, a buyer must perform adequate due diligence before it acquires the property. As discussed above, a buyer must conduct AAI into the previous ownership and uses of the property before acquiring the property.

It is important to note that performing a Phase I ESA is only one element of establishing the BFPP defense. In addition to conducting AAI, to establish the BFFP defense, a buyer must not have caused or contributed to the contamination and cannot be affiliated with any person who is potentially liable for the contamination, such as a former owner or operator of the property.[21] Other pre-purchase steps to establish the BFPP defense include the requirement that all disposal of hazardous substances on the property occurred before purchase and that the buyer bought the property after January 11, 2002.[22]

After purchase of the property, a buyer must take certain steps in regard to the existing contamination on the property in order to maintain the BFPP defense. The buyer must (1) exercise appropriate care for known hazardous substances by taking reasonable steps to stop any continuing release, prevent any threatened future release, and prevent or limit any human, environmental, natural resource exposure to any previous hazardous release; (2) cooperate with authorities, such as providing access to persons, if any, who are authorized to conduct response actions or natural resource restoration at the property; (3) comply with land use restrictions and institutional controls; (4) comply with all EPA information requests and administrative subpoenas; and (5) provide all legally required notices with respect to the discovery or release of hazardous substances at the property.[23]

The BFPP defense is not tested until a claim for cleanup costs is actually brought. Thus, a new buyer relying on the BFPP defense will not know its perceived liability from CERCLA is ironclad until the EPA or another party files a lawsuit seeking reimbursement for cleanup costs. Though the BFPP defense may appear impenetrable, it is important for a buyer purchasing a contaminated site to take steps not to release any existing contaminants further into the environment. For example, a buyer of a property with contaminated

soil capped with a parking lot cannot disturb the concrete parking lot without risking loss of the BFPP protection.

III. Scope of Environmental Due Diligence

While environmental due diligence should always be considered in a commercial real estate transaction, not all transactions warrant the same scope or level of environmental due diligence. For example, a transaction for real property that was formerly used as a dry cleaner likely requires more thorough environmental due diligence than a transaction for real property that was formerly vacant or used for residential purposes.

The scope of environmental due diligence can depend on a variety of factors. Some factors to be considered in determining the scope of due diligence necessary include: characteristics of the real property; past uses of the land; known contamination on the property or surrounding property; and the anticipated use of the property after purchase. Appropriate due diligence may range from a simple Phase I ESA to a more complex and intrusive Phase II ESA involving air, soil, water, and/or groundwater sampling at the property.

If a Phase I ESA does not identify any RECs in regard to the property, then there may not be a need for any further due diligence. However, it is important to note that there are certain environmental conditions that may exist on the property that are beyond the general scope of a Phase I ESA. A Phase I ESA does not generally address the following potential conditions: asbestos-containing materials, biological agents, compliance with activity and use limitations, cultural and historic resources, ecological resources, endangered species, health and safety, indoor air quality, industrial hygiene, lead-based paint, lead in drinking water, mold, radon, regulatory compliance, and wetlands.[24] Thus, in certain circumstances, it may be appropriate for a buyer to conduct a Phase II ESA or utilize other due diligence methods.

IV. Risk Management Methods

From conducting environmental due diligence, a buyer is able to identify and quantify environmental issues, and thus, is better equipped in deciding how to address these environmental issues. At the beginning of the transaction, the buyer should ensure that a due diligence provision is included in the purchase agreement. Generally, a due diligence provision in a purchase agreement should address the following items: the necessary time to complete the due diligence; the scope of the due diligence; and the positions and rights of the parties if contamination is discovered, such as the right to terminate the purchase agreement, the right to extend the closing date or the due diligence period, and the buyer and seller's liability related to conditions existing prior to and occurring after closing. Depending on the terms of the purchase agreement, if

contamination is discovered during the environmental due diligence process, the buyer often has several ways in which to address the risk associated with the contamination. For example, a buyer may decide to terminate the purchase agreement; it may negotiate the inclusion of certain provisions into the purchase agreement to allocate potential liability, such as representations, warranties, indemnities, and releases; it may opt to rely on statutory protections or programs, such as the BFFP defense or voluntary cleanup or "brownfields" programs; it may obtain environmental insurance; or it may use a combination of these strategies.