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Client Alert Commentary

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Digging in the Dirt? Allocating Environmental Liability in Real Estate Transactions

While adverse environmental conditions may be unavoidable, appropriate due diligence can help both real estate buyers and sellers avoid a liability mess.

The conveyance of commercial or industrial real estate often involves allocation of liability for environmental matters. Traces of the industrial age in the form of chemicals in soil and groundwater are unfortunately found in most industrial and commercial districts. In some cases, the history of industrial or commercial activities at a particular parcel can span decades or even centuries. Historic activities, both on- and off-site, can result in contamination that is undocumented and undiscovered. In many cases, the party who caused the contamination filed for bankruptcy or no longer exists. For the unwary and unsuspecting purchaser of industrial or commercial property, historic contamination can result in significant liability.

Do the Due Diligence

Environmental due diligence takes on greater importance where the real estate has a commercial or industrial past, because liability for environmental contamination can be strict (*i.e.,* liability for the contamination, regardless of fault) against the owner of the property. Under the Comprehensive Environmental Response, Compensation & Liability Act (CERCLA), 42 U.S.C. §§ 9601 *et. seq.*, liability attaches strictly to owners of contaminated parcels, among others. During the 1980s when CERCLA was first enacted, numerous accounts of draconian outcomes against "innocent" landowners (those who did not cause contamination) elevated the importance of environmental due diligence in real estate transactions. Ultimately, Congress and EPA realized that without amendment, CERCLA was resulting in outcomes that were arguably unfair and that discouraged beneficial reuse of urban industrial properties. The documented phenomenon of urban sprawl (the expansion of "developed" land outward from a central urban area) and a glut of decaying urban industrial areas, particularly in the eastern half of the United States, highlighted the need for statutory changes under CERCLA.

In January 2002, the Small Business Liability Relief and Brownfields Revitalization Act was passed to provide limited protections for innocent parties who purchase (or own) contaminated parcels. In order to take advantage of these limited protections, buyers must conduct "all appropriate inquiry" (AAI), which essentially means a thorough investigation into the property condition and history by a licensed environmental consultant.

AAI typically starts with a Phase I environmental site assessment (Phase I), which does not involve testing of soil and groundwater. Instead, a Phase I involves a review of databases and a site visit to the parcel with interviews of site personnel. A fulsome review of the property history is performed, noting any past industrial and commercial activities. The consultant will focus on material usage and waste disposal

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information, as well as any obvious indications of on-site activities that could have resulted in contamination, such as on-site operation of underground petroleum storage tanks. Where the consultant concludes that contamination is a reasonable possibility, the underlying issue (*e.g.,* an underground storage tank) will be characterized as a "recognized environmental condition." The consultant may recommend additional investigation in the form of a Phase II, which tests soil and/or groundwater.

Prepare for the Unknown

Often the suspected but unknown environmental issues present the greatest challenge for counsel and the parties. For example, where a property has a long history of industrial use and a number of predecessor owners, environmental impacts from historic operations are more likely to exist. The consultant's findings in the Phase I may be characterized as "potential" or "historic" in nature. Although the Buyer may want to conduct soil and groundwater testing in such a deal to develop an accurate picture of the environmental conditions, the Seller may rightly be concerned that intrusive testing may trigger additional liability for the Seller. Counsel must work to resolve these competing dynamics and interests of the parties in a manner that preserves each party's limited liability for unknown issues.

Document the Liabilities

The allocation of risk for environmental liabilities between buyers and sellers will be dictated by the terms of the purchase agreement. Environmental terms, such as "environmental laws," "permit" and "hazardous materials" will be defined. The Seller will be required to make certain representations regarding environmental conditions (together with scheduled exceptions), such as:

- The absence of hazardous materials at any conveyed real estate
- The absence of any government or third parties claims regarding contamination at any conveyed parcels
- The absence of any past on-site disposal activities and/or hazardous materials usage
- The Seller's provision of all material environmental reports

Depending on the deal particulars and the parties' negotiating leverage, the Seller's representations may be qualified. For example, the Seller may represent that it has "no knowledge" of the issues outlined above — which is commonly referred to as a "knowledge qualifier." In many deals based on "market" terms, knowledge qualifiers are typically used for environmental conditions at former sites and claims for environmental liability that have been threatened against Seller but not placed in writing. Where a Seller has significant leverage, such as an auction format with many interested prospective purchasers, the Seller may provide that the environmental representations are made except for those matters which, individually or in the aggregate, would result in a "material adverse effect" — which is commonly referred to as an "MAE qualifier." Use of an MAE qualifier means that the Buyer can only claim that Seller breached the environmental representation if the environmental liability is so significant that it rises to a "material" level.

The purchase agreement may provide an indemnity to the Buyer in the event that Seller's environmental representations prove untrue. This indemnity may, in general form, provide for Buyer's claims for the alleged breach of any representation; from tax, to contracts, to environmental matters. Where environmental issues are more significant, the parties may draft specific environmental indemnity provisions that provide detailed structure for investigating environmental issues, cleaning up contamination, and making and paying claims. Issues of control of cleanup are also typically allocated

within the more complex environmental indemnity provisions. While Buyers will want protection against future environmental liability, Sellers will be reluctant to issue a blank check for Buyers to engage in voluntary investigation and cleanup in the absence of a legal obligation or government order to do so. Language limiting a Buyer's ability to obtain indemnification for "voluntary" remediation is commonly referred to as an "anti-sandbagging" provision.

Consider Insurance

Beyond drafting contractual terms to allocate environmental liability, the parties may choose to explore environmental insurance policies to cover worst-case scenarios and facilitate the resolution of environmental liabilities. Insurance brokers can offer a number of competing quotes, each with its own terms, conditions and exclusions. The insurer will base the coverage decision on the same due diligence materials used by the deal team to assess environmental conditions at the property — Phase I environmental site assessments and any other material environmental documents. Where Buyers and Sellers are confronted with an impasse over potential or known environmental contamination, Buyers may push aggressively for a steep price cut or even seek to carve out the suspect parcel altogether. Environmental insurance can help eliminate the "worst case" scenario and monetize the risk at substantially lower levels than at "worst case" levels.

The challenge for environmental and real estate attorneys is to arrive at a mutually-acceptable risk allocation to cover known and unknown environmental issues, while preserving and protecting the limited liability of each entity.

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