ENVIRONMENTAL CONSIDERATIONS IN REAL ESTATE TRANSACTIONS: AN INTRODUCTION FOR GENERAL PRACTIONERS

By G. Alan Perkins[1]

I. Environmental Risks in Real Estate Transactions

The spectre of immense liability under environmental laws, most notably CERCLA or "Superfund,"[2] has radically altered the legal landscape of real estate transactions. Environmental contamination, at any level, creates a huge risk of liability for the buyer. The success of a commercial property acquisition may well depend on the attorney's ability to recognize and properly manage environmental issues. For these reasons, real estate attorneys must supervise and implement appropriate procedures to assess and minimize this risk for their clients.

A complete survey of environmental laws with potential affects on real estate transactions is beyond the scope of this presentation. Selected statutes which often impact real estate transactions in Arkansas, along with a brief summary, are presented in Exhibit "A." Of primary concern are federal and state laws which can impose tremendous liability on landowners for the presence of hazardous materials on the property, including CERCLA and the Arkansas Remedial Action Trust Fund Act ("RATFA"). Other laws such as the federal Clean Water Act, may seriously restrict a landowner's ability to develop the property for a desirable commercial purpose.

II. Environmental Due Diligence

Doing due diligence means to take appropriate steps to identify potential environmental problems, evaluate the nature and severity of the problems, and structure the transaction in an appropriate way to allocate or minimize risk for the client.

A. What you need to know.

A buyer should be able to answer the following questions in order to determine whether a particular transaction makes good sense:

1. Does any contamination exist on the property?
2. Does any contamination exist on nearby property?
3. Will any cleanup of the property be required, and how much will it cost?
4. If the property or existing structures will be developed or modified, will such activities require environmental compliance costs?

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[2] Comprehensive Environmental Response Compensation and Liability Act, 42 U.S.C. §§ 9601 et seq.

5. Will future use or development of the property be restricted or prohibited?
6. What is the chance of future liability to the government or third parties?

B. When to conduct due diligence.

The timing of environmental due diligence depends, in large part, on the complexity and structure of the proposed transaction. If the transaction is more complex or the environmental concerns are substantial, the process of environmental due diligence should be initiated as early in the process as possible.

Before signing a contract. Although it is somewhat unusual, some prospective buyers may perform due diligence before any contract is signed. The risk, of course, is that the hopeful buyer will expend significant sums investigating the property only to watch it be sold out from under him. However, in some circumstances, a potential buyer may want to conduct at least some informal discovery of environmental information prior to making an offer or initiating serious contract negotiations.

Option period. One alternative is to execute a letter of intent or an option contract. Such an agreement can provide a potential buyer with comfort that the property cannot be sold during the due diligence investigation. If the potential buyer discovers contamination or uncovers other unfavorable environmental facts, the buyer need not move forward. Such arrangements can be structured so that any option payment can be credited to the purchase price or, in some circumstances, be refunded. Substantively, such an option contract is not much different from an opt-out provision in a sales contract.

After the contract is signed. Typically, particularly in complex transactions, environmental due diligence occurs after an initial contract is signed. It often overlaps with other due diligence activities and continuing negotiations about various aspects of the transaction. Such contracts usually provide for a due diligence period, including opt-out provisions depending on the results of due diligence investigations.

III. Environmental Site Assessments

Environmental site assessments largely have emerged as a result of harsh liability statutes such as CERCLA. The so-called "innocent purchaser defense" under CERCLA excludes from liability a buyer that can establish that it acquired the property after the hazardous substance release occurred and that, before the acquisition, it had no knowledge nor any reason to know of the contamination, after having conducted "all appropriate inquiry" into the property's environmental condition.[3] Unfortunately, there is no clear interpretation of the meaning of "all appropriate inquiry." Nevertheless, it is clear that, by today's standards, a buyer typically should conduct some level of environmental assessment. If any material environmental issues exist pertaining to the property, the buyer should, at a minimum, arrange for a Phase I Environmental Site Assessment by an environmental professional.

[3] 42 U.S.C. § 9607 (35)(A) and (B).

A. ASTM Standards

The American Society for Testing and Materials ("ASTM") has developed three standards specifically related to environmental due diligence:

1. E 1527-97: Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process;
2. E 1528-96: Standard Practice for Environmental Site Assessments: Transaction Screen Process;
3. E 1903-97: Standard Guide for Environmental Site Assessments: Phase II Environmental Site Assessment Process.

The ASTM standard for Phase I Site Assessments is the most commonly used standard for commercial real estate. The standard for transaction screens essentially is a less rigorous version of a Phase I assessment, and does not have to be conducted by an "environmental professional." A Phase II site assessment typically is not conducted unless the Phase I assessment identifies environmental concerns that require additional study. In my experience, Phase II site assessments are much more project and/or site specific, and are not nearly as standardized as the initial assessments.

B. Environmental Consultants

Selecting an environmental consultant is one of the most important steps in ensuring that an environmental assessment is done properly and that your client can rely on the consultant's work product. There are a lot of good environmental consultants, but there also is no shortage of inept and inexperienced consultants who can miss crucial problems. A less competent consultant can, for example, use improper analytical techniques, neglect to recommend appropriate follow-up investigations, miss critical liability issues, or fail to provide your client with a proper statement of results. Furthermore, all too often, your client may want to "shop" for the lowest priced assessment money can buy. This is almost always a mistake. The attorney can provide valuable assistance in selecting the consultant, reviewing or editing the consultant's contract or scope of work, dictate the appropriate assessment standard to be applied, and ensure that the report is complete.

IV. Structuring the Transaction to Allocate Environmental Liability

Even if no contamination is discovered on the property before closing, potential environmental liabilities must be identified and should be minimized by appropriate provisions in the deal. There is always *some* risk of environmental liability in any real estate transaction, and the real estate lawyer must ensure that the risk is allocated in a manner most beneficial to his client. A mistake in allocating environmental risk could easily render the entire transaction financially unsound.

Generally speaking, a seller of real estate wants to sell the property "as is" with full releases and indemnities from the buyer, with as little impact on price and central terms as

possible. Conversely, the buyer's objective will be to purchase the property free from all environmental liabilities arising from operations prior to closing with an indemnity from the seller for such conditions. Either party will want to make the other bear as much of the cost of environmental investigation as possible.

Numerous techniques are available for handling and allocating environmental risks. Some commonly used techniques include the following:

1. representations and warranties;
2. indemnification agreements;
3. covenants;
4. "hammer" provisions;
5. legal and consultant opinions;
6. holdbacks and escrows;
7. insurance;
8. guarantees or certifications by company officers;
9. cutting the risk out of the deal;
10. cleanup before closing;
11. formula allocation of environmental liabilities.

Environmental investigation and cleanup represents an enormous potential expense in real estate transactions. The parties, and their counsel, should take the time to consider carefully the appropriate allocation of responsibility and risk related to environmental issues. Careful planning and drafting will help your client avoid the potential pain and expense of litigation regarding relative allocation issues, which can take years to resolve.

Suggested References

American Bar Association, Environmental Aspects of Real Estate Transactions (Witkin, Ed. 1995)

BNA's Environmental Due Diligence Guide, Bureau of National Affairs, Inc. (2000)