ENVIRONMENTAL 101

FOR PURCHASERS OF PROPERTY IN WASHINGTON STATE

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L A W Y E R S

Environmental considerations exist in any significant real estate transaction, whether the property at issue is industrial, commercial, or residential. While we may be less surprised when industrial or commercial properties suffer impacts from prior uses, such adverse impacts can also exist on residential properties where, perhaps, previous fill materials contained "dirty dirt" or where past paint removal operations resulted in lead-contaminated soil. Even undeveloped parcels can show impacts, especially where off-site activities may have affected the underlying soil and groundwater.

Most of us recognize the usual environmental suspects: the aboveground or underground storage tanks, the abandoned drums and containers, the nearby dry cleaner, the up-wind smelter, or the unsightly landfill or waste storage facility. But what about the not-so-obvious environmental risks, like those associated with the purchase of an older building, undeveloped agricultural land, or a downtown corner retail shop? We would normally not consider these properties to carry any significant environmental risks but that is not always the case. Buildings constructed in the mid-1970s or earlier may contain asbestos in the floors, roofs, or construction materials (e.g., electrical equipment, electrical panel partitions, electrical cloth, wiring insulation or pipe insulation). Property located in an agricultural zone may have soil or groundwater contamination resulting from the past use of chemical substances such as fertilizers, and herbicides and pesticides. A centrally located commercial property may have underground storage tanks that were buried years earlier when a service station occupied the site.

Seen or unseen, environmental hazards can cause challenges for prospective purchasers, especially given current environmental laws. Under Washington's version of the federal Superfund law, the Model Toxics Control Act ("MTCA"),[1] a current owner or operator of a facility at which there has been a release of hazardous substances is liable for remedial action costs, including attorneys' fees and costs, resulting from that release absent the application of one of MTCA's limited defenses. "Owners or operators" are defined as "*any* person with *any* ownership interest in the facility or who exercises any control over the facility." RCW 70.105D.020(12). And liability attaches as soon as the property owner takes title, regardless of fault or causation.

Understandably, the prospect of "buying-into" an environmental liability is not an appealing concept to many clients. Prospective purchasers can take steps to shield themselves from liability and limit their exposure within a particular transaction. To take advantage of these options, however, buyers should learn as much as they can about the property's environmental condition before they buy. This includes learning about conditions on adjacent properties that may already affect the property your client is considering for purchase or could do so in the future.

This article provides an overview of the environmental due diligence process and discusses what steps are necessary to qualify for the "innocent purchaser" defense, one of the limited MTCA defenses available to buyers who can establish that they had no reason to know of environmental problems before they purchased the property. The due diligence issues discussed in this article are equally important, however, to prospective purchasers who know of environmental issues and who want to structure their transaction to minimize their exposure to the costs and liabilities associated with those environmental problems. Due diligence allows these prospective purchasers to identify early on the environmental issues that might delay or otherwise impact their development plans and to evaluate what it might take to clean up the subject property. Lastly, this article also provides some tips on how your clients might tailor an indemnity to allocate environmental liability between themselves and the sellers.

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What Is an Innocent Purchaser?
The innocent purchaser defense is one of two "third-party" defenses recognized under MTCA and the one most commonly asserted by property owners facing environmental liability.[2] To qualify as an innocent purchaser, owners must show that they undertook "all appropriate inquiry"[3] into the previous ownership and uses of the property at the time of their purchase. The innocent purchaser must also show that, based on their investigation, they had no knowledge nor any reason to believe that hazardous substances are or were released at the property, "the release or threatened release of which has resulted in or contributed to the need for the remedial action" on, in, or at the property. *See* RCW 70.105D.040(3)(b). The innocent purchaser defense is not available to a property owner who causes or contributes to a release of hazardous substances. It is also not available to the owner who fails to conduct "all appropriate inquiry" (i.e., adequate due diligence).

What Is All Appropriate Inquiry?
All appropriate inquiry ("AAI") is a term of art that refers to the requirements for assessing the environmental conditions present on a particular piece of property. The U.S. Environmental Protection Agency ("EPA") recently promulgated regulations establishing the standards for conducting AAI. These new regulations, which became effective in November 2006, were developed in response to the 2002 Brownfields Amendments to CERCLA. The regulations expanded the scope of inquiry that had been required under the previous standard, which was published by the American Society for Testing and Materials ("ASTM"), a non-profit standards-writing organization. ASTM has since updated its standards to comply with the new EPA regulations, and the new standard, titled "Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process (E1527-05)" (the "New Phase I Standard"), is consistent with EPA's regulations and can be used to comply with the AAI requirements.

Like earlier versions, the New Phase I Standard requires that a site assessment include the following four components:

- A records review to identify past uses of the property and adjacent properties that might indicate environmental issues. Typically, the records reviewed include regulatory information from federal and state databases, aerial photographs, Sanborn Fire Insurance Maps, tax records, Polk directories, local construction and land use records, and historical maps.
- Site inspections to identify signs of past spills and practices that might result in contamination. Commonly, the environmental professional will be looking for the presence of above and underground storage tanks, wells, sumps, drains, stressed vegetation, and stained soil.
- Interviews with current owners, tenants, and government officials to identify a potential condition that may have contributed to contamination.
- A report outlining the environmental professional's opinion regarding potential environmental impacts on the subject property and the logic and reasoning used to arrive at that opinion.

The New Phase I Standard goes further, however, by requiring specific educational requirements for the environmental professional who manages or supervises the investigation. The qualified environmental professional must have, at a minimum, (i) a state or tribal issued certification and three years' experience; (ii) a relevant Baccalaureate degree or higher and five years' experience; or (iii) ten years of relevant full-time experience.

The New Phase I Standard also requires a more rigorous interview process that includes mandatory interviews with current owners and occupants of the property, past owners and occupants, and, at abandoned properties, neighboring property owners or occupants. The New Phase I Standard also broadened the records review requirement to include a review of records from the time that the property first contained structures or was used for any purpose, to the present. The New Phase I Standard requires that the environmental professional disclose any identified data gaps in his/her evaluation and comment on the significance of those gaps in evaluating whether recognized environmental conditions exist. Lastly, the New Phase I Standard changed the shelf life for the Phase I assessment. Previously, a report was considered valid for only six months from the date it was issued. The New Phase I Standard contains the same six-month limitation but it also allows a prospective purchaser to use a previous assessment if the information in that assessment was collected or updated within one year prior to the date of acquisition or,

where the transaction does not involve an acquisition, the date of the intended transaction. However, to use the previous assessment, prospective purchasers must update certain portions of the report—like the records review, visual inspections, and interviews—within 180 days of the purchase date or the date of the intended transaction.

All Phase I Assessments Are the Same, Right?
No. Even though the New Phase I Standard mandates a minimum level of inquiry, site assessments can vary substantially, depending on the consultants conducting and supervising the investigation. The Phase I with the lowest price tag may come with the consultant with the least experienced consultant. A low-cost Phase I may also mean that less is done to analyze and understand the available information or to draft and develop the final report. A low-cost assessment may simply provide a laundry list of information without ever explaining how that information informs the decision as to whether environmental concerns exist.

A substandard Phase I report is also risky for your clients. A poorly performed investigation is less likely to satisfy the AAI requirement, thereby making it less likely that your clients will qualify as innocent purchasers. An unreliable report may also result in your clients paying more than necessary for contaminated property or underestimating environmental problems in their negotiations with their sellers. This last scenario can be quite costly, especially if the consultant's contract limits its liability. Consider the case of a client who reserved $300,000 from a property transaction based on the consultant's estimate. When the actual cost of cleanup exceeded $1.5 million, the client has no recourse against the consultant for its negligence because the contract limited the consultant's liability, much like many consulting contracts, to the project fee or $50,000, whichever was greater. For reasons like this, it is important that you carefully review the consulting contract and negotiate protective terms like reasonable limitations of liability that reflect the risk associated with the transaction. Unless your clients negotiate specific terms in their consulting contracts, the terms they receive will most likely be heavily weighted in favor of the consulting firm.

The consultant and lawyer should also work together to refine the scope of work. It is important to tailor a site assessment to the specific property that is being investigated, the ultimate goals of the client, and the overall costs involved in the transaction. Some transactions require that the site assessment include work that is beyond the scope of the New Phase I Standard, like evaluating environmental compliance issues where the purchase involves an ongoing business or testing for asbestos or lead-based paint. Lastly, an environmental lawyer or someone skilled in reviewing environmental assessments should review the final Phase I report to determine if any identified concerns require further investigation.

Using Indemnities to Allocate Environmental Liability
If environmental problems are identified on a piece of property, your clients will want to consider how to structure the transaction to limit potential liabilities.[4] As explained above, environmental liabilities require special consideration because the laws and their consequences are more stringent. The provisions in a real estate contract dealing with environmental conditions, therefore, need to be specifically tailored to address those issues. Buyers should not assume that a contract's general provisions will protect them from future environmental liability.

Buyers commonly use indemnities, for example, to transfer pre-closing liability to the seller. A general indemnity agreement, however, will rarely be sufficient to transfer environmental liabilities. Washington courts require that parties include specific language in their agreements if they intend provisions to clearly encompass environmental losses. *See e.g., Scott Galvanizing, Inc. v. Northwest Enviroservices, Inc.,* 120 Wn.2d 573, 844 P.2d 428 (1993); *see also Car Wash Enterprises v. Kampanos,* 74 Wn. App. 537, 874 P.2d 868 (1994) (holding that an "as is" clause that made no mention of environmental conditions was not sufficiently specific to pass liability on for future environmental liability, despite the buyer's knowledge that a service station had operated on the property). In *Scott Galvanizing,* a metal galvanizing company ("Scott") sought indemnity from a waste transporter ("Northwest") for its liability under CERCLA. A Hazardous Waste Agreement between the companies contained an indemnity provision that provided that Northwest would indemnify and hold Scott harmless from any and all liability including liability associated with pollution:

> [Northwest] agrees to indemnify and hold [Customer] harmless from any and all liability, damages, costs, claims, demands and expenses (including reasonable attorney fees), including but not limited to

pollution or other damages, as and to the extent that such liability, damages, costs, claims, demands and expenses are caused by, arise out of or in any manner result from the performance by [Northwest] of its services under this agreement or arise out of the negligence of [Northwest] provided, however, that the loss or claim does not result from the misidentification or failure to properly identify the materials by the Customer or the negligence of the Customer.

Id. at 577 (alterations in original) (emphasis added). When Scott was sued for cleanup of a disposal site, it argued that the indemnity required Northwest to indemnify it for all past and future costs associated with Northwest's transport of waste to that site. *Id.* at 578. Northwest argued that its duty to indemnify only applied to the extent that the liabilities arose because of Northwest's performance under the contract. Because Scott's liability arose independently of the Hazardous Waste Agreement, Northwest argued it had no obligation to indemnify Scott for its claims. *Id.* at 583. In reversing the lower court's ruling on summary judgment, the Supreme Court held that an issue of material fact existed with regard to the "intent of the parties in executing the indemnity clause." *Id.* at 584.

At a minimum, an environmental indemnity should describe the environmental harms that the provision is intended to cover, the claims that will trigger the indemnity, the specific facilities that fall within the coverage, and how the parties plan to handle disputes regarding the indemnity obligations. The indemnity (or another part of the contract) should also contain a statement indicating how long that the parties intend the environmental indemnity to survive. Otherwise, an environmental indemnity will expire at the same time (usually at closing) as other provisions in the agreement. And, of course, an indemnity is also only as good as the financial condition of the entity providing it. An indemnity is of little value if the entity providing it does not have the assets needed to meet its obligations or is likely to dispose of its assets. It makes sense therefore to check the financial health of the indemnitor before relying on an indemnity provision.

While useful, an indemnity is not a substitute for conducting thorough due diligence on a piece of property. Even though an indemnity from a financially sound seller may protect your client from liability, it may cost your client considerable resources to enforce it. You will want to ensure that your clients consider those costs when evaluating the property purchase as a whole.

Conclusion

Environmental risk should not deter your clients from proceeding with a property transaction. Armed with a thorough understanding of the environmental concerns at issue, your clients will be better able to evaluate the purchase and, if necessary, to take the steps to limit their exposure and allocate liability as between themselves and other parties. This article offers some general advice on handling these issues, but it is no substitute for discussing real-life situations with an environmental lawyer or other experienced practitioners. Each transaction is different and each requires considerations specific to that particular deal. Your clients will save themselves money and years of grief if they take the time to properly investigate environmental risks and to hire and consult with the appropriate advisors.

FOOTNOTES

1 MTCA was modeled after the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") and there are many similarities between the two statutes.

2 The other "third-party" defense recognized under MTCA is often referred to as the innocent landowner defense, which requires that an owner show that the release of hazardous substances was caused solely by a third party with whom the current owner did not have a direct or indirect contractual relationship. *See* RCW 70.105D.040(3)(a)(iii). Owners must also show that they exercised "utmost care" with respect to the hazardous substance and foreseeable acts or consequences of the third party. While there are some differences in what owners must demonstrate to qualify for the innocent landowner and innocent purchaser defenses, at least one commentator has said that the level of inquiry required under the two defenses is similar.

3 Inquiry into the environmental condition of a property is also required to qualify for two other liability limitations under MTCA. The passive migration or "plume" defense exempts a property owner from liability under MTCA so long as they can show through an environmental investigation that hazardous substances have come to be located on the property solely as a result of migration through the groundwater from an off-site source. *See* RCW 70.105D.020(12)(iv). Similarly, a property owner can limit the extent of its liability by entering into a prospective purchaser agreement with the Attorney General and Department of Ecology. *See* RCW 70.105D.040(5). These agreements are sometimes used by developers who want to redevelop or reuse contaminated property. To qualify for a prospective purchaser agreement, developers first must fully characterize the property to demonstrate that they are not somehow responsible and that they have a thorough understanding of the site's cleanup needs.

4 Note that buyers and sellers cannot use their contractual agreements to avoid an underlying environmental liability, but they can determine between themselves whether the buyer or seller will be responsible to pay any costs associated with such liability.