



Mitigating Risk Through Environmental Due Diligence in California Real Estate Deals

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Outline – Why Environmental Due Diligence?

I. Purpose

II. Roles

III. Scope

IV. Environmental Site Assessments

I. Purpose of Environmental Due Diligence

- Should be undertaken when acquiring any interest in commercial property
- Includes purchase & sale, finance, and corporate RE transactions
- Allows the discovery of actual/potential contamination
- Broad Liability--extends to sellers, past owners, purchasers, tenants, operators, lenders, & insurers

I. Purpose

- Allows parties to allocate risk among themselves in mutually acceptable ways
- Examines historical uses of hazardous substances at or near the property
- Reveals existence of hazardous building materials in property improvements
- Key: Scope of EED depends on property characteristics, nature of the transaction, and parties' risk tolerance

I. Purpose

Critical Focus:

- Many properties have environmental issues
- Without EDD, purchaser/lender may unknowingly risk loss of property value or incur liability for remediation
- Example: Contamination from hazardous substances is found after closing

I. Purpose

Thorough EDD especially important when the property involves companies with current/past industrial operations:

- **Petroleum**
- **Chemicals**
- **Manufacturing**
- **Automotives**
- **Energy**
- **Agriculture**
- **Dry cleaning**

I. Purpose

- **Query**: What lurks beneath the surface of real property that may not have been used recently in a manner that suggests contamination is likely?
- **Could be:**
 - Retail or educational facility built on former landfill
 - Multi-family residential project built on former drycleaner site
 - Restaurant constructed on former gas station site

II. Roles in Environmental Due Diligence

- Environmental risks will impact transaction if not properly addressed during EDD:
 - Decreased property value due to discovery of environmental contamination (impacts seller, purchaser and lender)
 - Later cleanup may interfere with purchaser's business operations and income (impairing ability to repay loan)
 - Government agency may restrict future property uses
 - Lender may be jointly and severally liable for cleanup costs if it cannot gain protection (e.g., CERCLA Secured Creditor Exemption; similar state exemptions)
 - Lender foreclosure could lead to liability as *de facto* property owner

II. Roles

- Proper EDD may entitle purchaser to qualify for liability protections under CERCLA's Bona Fide Prospective Purchaser exemption
- Lender may qualify for Secured Creditor exemption

II. Roles

To qualify for either exemption, an Environmental Site Assessment (“ESA”) must be conducted to examine previous property ownership and uses.

ESA must:

- Comply with (1) EPA’s “All Appropriate Inquiry” Rule and (2) American Society for Testing and Materials (ASTM) Standard
- Be consistent with good commercial/customary practice.
 - ESA performed by an environmental consultant generally consists of a Phase I and Phase II (if necessary)

III. Scope of Environmental Due Diligence

EDD should cover:

- Investigation into previous/current property uses and conditions, including “Recognized Environmental Conditions” (RECs) under ASTM standards
- Assessment of potential liability for on- and off-site contamination
- Review of compliance history and status
- Analysis of litigation and environmental enforcement risks
- Anticipated regulations which could potentially impact business
- Occupational/Residential health and safety exposures
- Federal/state FOIA requests for information not readily available

Common Disclosures and Requirements

- **Cal. Health & Safety Code § 25359.7**
- **Common Law Duties**

Common Disclosures and Requirements

1. Cal. Health & Safety Code § 25359.7

- Section 25359.7 is critical statutory disclosure law for environmental matters.
- Key point: Owners/lessors/sellers of commercial property with knowledge of hazardous substances on their property must give written notice of the condition to buyers.

Common Disclosures and Requirements

1. Cal. Health & Safety Code § 25359.7 (cont.)

- Penalties for failure to give notice
 - Actual damages: Buyer can subject seller to, among other things, cleanup and other costs
 - Civil penalties: If seller knowingly/willfully fails to disclose, seller can be subject to penalties up to \$5,000

Common Disclosures and Requirements

1. Cal. Health & Safety Code § 25359.7 (cont.)

- Disclosure best practices: Section 25359.7 disclosure can either be in purchase & sale agreement or a separate written disclosure.
- If based upon environmental report(s), parties should identify each by reference and/or attach copies

Common Disclosures and Requirements

2. Common Law Duties

- Seller also has a common law duty to disclose to purchaser certain facts that:
 - Are known or accessible only to seller;
 - Materially affect the value/desirability of the property;
and
 - Are unknown to or not within the reach of the diligent attention and observation of purchaser

Common Disclosures and Requirements

2. Common Law Duties (cont.)

- Examples of matters that may require disclosure to buyer
 - Third-party inspection or report
 - Any claim/notice made by seller to insurance company re property condition
 - Unusual event affecting property (e.g., criminal activity, industrial accident)

IV. Environmental Site Assessments

The Principal EDD Mechanism

- Consultant generally performs Phase I and Phase II ESA (if necessary) according to the ASTM standard or AAI rule.
- Generates report summarizing findings and recommendations in each ESA.
- Phase I ESAs do not alone protect parties from potential exposure for environmental liabilities. They are informational in nature and are but one element of obtaining CERCLA liability protection

IV. ESAs

Phase I ESA generally includes:

- Tour of the property and on-site facilities
- Interviews of current owners/operators and neighboring landowners
- Review of:
 - Agency compliance
 - Data for permits, permit applications, compliance records, and enforcement and litigation materials;
 - Property and area maps;
 - Photos of property; and
 - Visual observations of adjacent properties.

IV. ESAs

- If Phase I ESA suggests the site may be contaminated, consider **Phase II**.
- Phase II may include:
 - Soil sampling
 - Groundwater analysis
 - Installation of monitoring wells
 - Air sampling (including vapor intrusion)
 - Mold sampling
 - Asbestos sampling
 - Lead testing; and
 - Locating and testing USTS
- Environmental consultants generally conduct Phase I and Phase II ESAs on behalf of purchasers, sellers and lenders

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