

Panel #15

***Clean up your Act! The Latest Developments in
Contaminated Properties Liability***

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Recent Toxics Issues in Due Diligence and Transactions¹

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I. Developments in Due Diligence

Environmental due diligence is typically begun with an environmental investigation of real estate. Environmental investigations are commonly referred to as "Phase I Environmental Assessments," or "Preliminary Site Assessments," etc. It is important for attorneys to be involved in defining the scope of work for environmental due diligence.

The scope of work in turn can find a source in the requirements of a buyer.² For instance, if a SBA loan is sought, the borrower must understand the three primary levels of due diligence. These include an environmental questionnaire (low risk loans <\$150,000); a Records Search with Risk Assessment ("RSRA") (low risk loans >\$150,000; and an ASTM 1527-05 Phase I Environmental Site Assessment for properties considered "environmentally sensitive."

The "California Superfund," the Hazardous Substance Account Act ("HSAA"), Health & Safety Code §25100 et seq., defines "Phase I Environmental Assessment," and "Preliminary Endangerment Assessment." *Id.*, §§ 25319.1, 25319.5. In contrast, the "federal Superfund"

¹ This paper was delivered to the 2011 Annual Retreat of the Real Estate Section of the California Bar. This version of the paper is updated and revised to include citations and some additional text. I thank Jim Brake, PG, Geocon Consultants, Inc., Rancho Cordova, CA, brake@geoconinc.com, for his review and questions. Mr. Brake was also a panelist at this session of the Retreat, and spoke on "vapor intrusion and non-scope considerations" in due diligence investigations.

² Note: Buyers, lenders, et al., dictate varying levels of due diligence. Not only do they ask for less than AAI/E 1527 due diligence, they also sometimes ask for more, e.g., vapor intrusion, et al.

(the Comprehensive Environmental Response and Compensation Act of 1980, as amended, 42 U.S.C. §9601 et seq. ("CERCLA")) doesn't define, at least in any direct way, what types of environmental investigations are appropriate for due diligence.³ So, in federal law, "due diligence" is defined as an element of the "innocent purchaser" defense to Superfund liabilities.

A. "All Appropriate Inquiry" -- Introduction

Current owners of real estate in California are liable, without fault, for investigation and clean up of hazardous wastes on their property.⁴ Section 107(a)(1), Comprehensive Environmental Response and Compensation Act of 1980, as amended, 42 U.S.C. §9607(a)(1) ("CERCLA").⁵

The 1986 amendments to CERCLA added the "innocent owner" defense, based on "all appropriate inquiry." Section 101(35)(A)(i), 42 U.S.C. §9601(35)(A)(i). In 2002, the Brownfields Amendments to CERCLA directed USEPA to develop a rule with standards and practices for doing "all appropriate inquiries." USEPA issued its "AAI Rule," effective Nov. 1, 2006, in Part 312, Title 40 CFR.⁶ At the same time, the American Society for Testing and Materials ("ASTM") developed a standard, ASTM E1527-05 for Phase I Environmental Assessments. USEPA accepts the ASTM standard as consistent and compliant with USEPA's "AAI Rule."⁷

³ The other duo of statutes one must keep in mind are the federal Resource Conservation and Recovery Act, 42 U.S.C. §6901 et seq. ("RCRA"), and California's Hazardous Waste Control Law, H&S Code §25100 et seq. ("HWCL"). While these do not include specific references to "due diligence," they do affect the liability of former and current owners and operators, as well as buyers, tenants, and lenders. And, there are additional statutes in California that impose liability for contamination, such as the Porter-Cologne Water Quality Control Act, Water Code §1300 et seq.

⁴ Note: There is a difference in strict legal definition between "hazardous wastes" and "hazardous substances." Either term is correct in general discussions, but RCRA/HWCL deals with "hazardous substances" that can result in "hazardous wastes," and CERCLA/HSAA deals with "hazardous wastes" -- which are what we have when hazardous substances are disposed -- or "abandoned" in California. See H&S Code 25113(a)(2). In other words, CERCLA/HSAA were enacted to clean up abandoned hazardous wastes; RCRA/HWCL were enacted to manage hazardous substances "from cradle to grave."

⁵ A "responsible party," or "liable person," for the purposes of the California Hazardous Substances Account Act (the "California Superfund" or "HSAA") includes those person described in Section 107(a) of CERCLA. Health & Safety Code, §24323.5(a)(1). And, the defenses available to a "responsible party" or a "liable party" are those in Sections 101(35) and 107(b) of CERCLA. Health & Safety Code §24323.5(b).

⁶ USEPA published the All Appropriate Inquiry Rule on Nov. 1, 2005. The Rule became effective Nov. 1, 2006. 70 F.R. No. 210, pp. 66069-66113.

⁷ This progression, from 1980, to 1986, to 2002, to 2006, provides today definite rules for establishing a bona fide purchaser defense to CERCLA "owner" liability. See J. Arnold & J. Grannis, "The New 'All Appropriate Inquiry' Rules' Rules May Mean More Consistency and Accuracy in Phase I Environmental Assessments," 2006 *California Environmental Law Reporter*, No. 4, p. 159 (Lexis/Nexis). Also, EPA has stated that ASTM Standard E1527-05 is consistent with the AAI final rule. Environmental Protection Agency, Comparison of the Final All Appropriate Inquiries Standard and the STM E1527-00 Environmental Site Assessment Standard, at 1 (2005), http://www.epa.gov/brownfields/aai/compare_astm.pdf.

“CERCLA's innocent owner defense encourages prospective property buyers to conduct soil investigations.” *US v. CDMG Realty Co.*, 96 F.3d 706, 721 (3d Cir. 1996). Among other things, the "innocent owner" defense requires that when an owner acquires a property, it, he or she "... did not know *and had no reason to know* that any hazardous substance which is the subject of the release or threatened release was disposed of on, in, or at the facility.” Section 101(35)(A)(i) (Emphasis supplied.)

How does an owner today prove that it had "no reason to know" of a prior disposal of hazardous waste?⁸ The components of "all appropriate inquiry" include 8 elements:

An owner must prove each of the following eight elements, A-H:

"(A) Disposal prior to acquisition

All disposal of hazardous substances at the facility occurred before the person acquired the facility.

(B) Inquiries

(i) In general

*The person made **all appropriate inquiries** into the previous ownership and uses of the facility in accordance with generally accepted good commercial and customary standards and practices in accordance with clauses (ii) and (iii).*

(ii) Standards and practices

The standards and practices referred to in clauses (ii) and (iv) of paragraph (35)(B) of this section shall be considered to satisfy the requirements of this subparagraph

....

(C) Notices

The person provides all legally required notices with respect to the discovery or release of any hazardous substances at the facility.

(D) Care

The person exercises appropriate care with respect to hazardous substances found at the facility by taking reasonable steps to-

⁸ In general terms, "waste" and "substance" are interchangeable. However, the Agency for Toxic Substances and Disease Registry (<http://www.atsdr.cdc.gov/>) defines "hazardous waste" as "Potentially harmful substances that have been released or discarded into the environment. " <http://www.atsdr.cdc.gov/glossary.html#G-G->

- (i) stop any continuing release;*
- (ii) prevent any threatened future release; and*
- (iii) prevent or limit human, environmental, or natural resource exposure to any previously released hazardous substance.*

(E) Cooperation, assistance, and access

The person provides full cooperation, assistance, and access to persons that are authorized to conduct response actions or natural resource restoration at a ... or facility (including the cooperation and access necessary for the installation, integrity, operation, and maintenance of any complete or partial response actions or natural resource restoration at the vessel or facility).

(F) Institutional control

The person-

- (i) is in compliance with any land use restrictions established or relied on in connection with the response action at a ... facility; and*
- (ii) does not impede the effectiveness or integrity of any institutional control employed at the ... facility in connection with a response action.*

(G) Requests; subpoenas

The person complies with any request for information or administrative subpoena issued by the President under this chapter.

(H) No affiliation

The person is not-

- (i) potentially liable, or affiliated with any other person that is potentially liable, for response costs at a facility through-*
 - (I) any direct or indirect familial relationship; or*
 - (II) any contractual, corporate, or financial relationship (other than a contractual, corporate, or financial relationship that is created by the instruments by which title to the facility is conveyed or financed or by a contract for the sale of goods or services); or*
- (ii) the result of a reorganization of a business entity that was potentially liable."*

42 U.S.C. §9601(40).

B. How have the Courts applied the "AAI Rule" (ASTM E1527-05) since 2006?

There are a few reported decisions.

***Amcal Multi-Housing, Inc. v. Pacific Clay Products*, 457 F.Supp.2d 1016 (CD Calif. 2006)**

Plaintiff's environmental consulting firm did Phase I and Phase II investigations on former clay and/or ceramic manufacturing site in Los Angeles. Plaintiff learned of use of the site for manufacturing fired clay products, underground and above ground storage tanks, petroleum hydrocarbon contamination, and surface contamination from lead and other heavy metals. Plaintiff closed on the deal. During demolition of buildings, Plaintiff found buried kilns, tunnels, drainage channels, bricks, pottery shards, and buried lead putty like waste. Plaintiff reported the hazardous wastes to the Fire Department, the Los Angeles Regional Water Quality Control Board, and the Department of Toxic Substances Control. The cleanup cost \$6 million, and redevelopment was delayed 9 to 12 months. The court held that Plaintiff was justified in not finding the buried lead waste because of the unknown buried structures (kilns, tunnels, etc.), but that the Complaint did not allege compliance with other requirements for "All Appropriate Inquiry," so lawsuit dismissed with leave to amend.

***Bonnieview Homeowners Association, LLC v. Woodmont Builders, LLC*, 655 F.Supp.2d 473 (DNJ 2009).**

Plaintiff homeowners purchased their homes on old orchard site after doing "...a facility inspection and title search that reveal[ed] no basis for further investigation." 42 U.S.C. §9601(40)(B)(iii) (*i.e.*, only a limited form of "AAI" is required for nongovernmental or noncommercial purchasers). And, they were not required to use "appropriate care" for hazardous wastes, etc., because they did not find hazardous wastes. The court ruled that these homeowners had the innocent owner defense because they had met the "all appropriate inquiry" standard. Plaintiff's motion for summary judgment on counterclaims granted.

***Ashley II of Charleston, LLC v. PCS Nitrogen, Inc.*, 746 F.Supp.2d 692 (DSC 2010).**

Plaintiff Ashley II (affiliated with national brownfields developer Cherokee Investment Partners) had its environmental consultant do a Phase I Environmental Assessment on one parcel (the "Allwaste parcel") of several parcels at a site before buying the single parcel in 2008. The first important lesson of the *Ashley II* decision for real estate attorneys is that Plaintiff relied on its environmental consultant and so met the AAI Rule requirements before it purchased the "Allwaste parcel." (The consultant had conducted its investigation according to the ASTM E1527-05 requirements -- the USEPA recognized equivalent of the "AAI Rule.")

However, the court also found that Plaintiff "did not exercise *appropriate care* with regard to hazardous substances" found at the site (see (D), above, the 4th requirement, 42

U.S.C. §9601(40). So the Plaintiff, although doing a correct pre-purchase investigation, was found by the court to not take "due care" after purchase to deal with what was found. This is the second important lesson of the *Ashley II* decision. The court explained what the Plaintiff failed to do:

1. Did not clean out and fill in sumps identified by its consultant as "RECs." ("Recognized environmental conditions" per ASTM E1527-05.) Possible releases may have resulted while the sumps were exposed.
2. Did not prevent debris pile from accumulating at site. Did not investigate contents of debris pile. Left debris pile on site for over a year.
3. Failed to adequately maintain a cover of a limestone run of crusher ("ROC") layer that is graded to promote better drainage.
4. Allowed debris pile to accumulate on site.

The result? The court held that Plaintiff Ashley II did not have the "innocent purchaser" defense. Plaintiff was liable for an allocated share of the present and future cleanup costs. (However, it was only responsible for 5% of the costs, due to several equitable factors accepted by the Court.)

II. Trends/Developments in Structuring Deals (Risk Management)

A. Insurance

Environmental insurance for transactions and brownfields redevelopment continues to evolve. The insurance is "gap" or specialized insurance. The underwriting is not based on statistical analysis of historic losses. Instead, it is based on identifying elements of risk and then conducting focused engineering analyses.⁹ And, a further distinction must be made between "remediation cost cap" insurance¹⁰ and the other types of "environmental insurance." These are seen as two types of "markets."¹¹

Practice Tip: *Expect insurance providers to require a commitment to reimbursement for their technical review of environmental conditions, including Phase I and Phase II environmental site assessments, Remedial Action Plans, etc.*

⁹ As explained by Bill McElroy, currently Senior Vice President, Liberty International Underwriters, and Todd S. Davis, currently Chief Executive Officer, Hemisphere Development, in "Environmental Insurance in the Brownfields Transaction," published as Chapter 11 in "Brownfields, A Comprehensive Guide to Redeveloping Contaminated Property," SEER (2d ed., 2002), at pp. 155 *et seq.*

¹⁰ Also known as cleanup cost cap ("CCC") or remediation stop loss insurance.

¹¹ Insurance law has its own esoteric terms. For instance, an "insurance market" is essentially the buying and selling of insurance. Specialized "markets" refers to buying and selling specialized types of insurance.

The present situation includes one “market” for *remediation cost cap insurance* and another “market” for the other varieties or types of environmental insurance. The latter include insurance coverages for *pollution legal liability* ("PLL")¹², *contractor’s pollution liability* ("CPL"), *professional liability or professional errors and omissions* ("E&O"), *lender's pollution liability* ("LPL"), and *liability of directors and officers* ("D&O").¹³

In 2009 there was concern about the near collapse of AIG. However, AIG's regulated insurance subsidiaries were considered to have sufficient reserves for claims that might arise from many brownfields projects. (AIG's successor is Chartis.)

Four things are happening today. *First*, third-party claims are increasing. *Second*, bankruptcies and restructurings of industrial entities are increasing (*e.g.*, GM, Asarco, and Lyondell), leaving unsettled significant environmental liabilities. *Third*, credit is significantly restricted from what it has been the last few years, with the result that lenders are wary of relying on environmental indemnities. *Fourth*, regulatory programs will increasingly require financial assurance, such as environmental insurance, for potential cleanups that result from business activities.¹⁴

Fortunately, there are more insurance carriers available, with adequate funding, to provide insurance. There are currently several environmental insurance providers. These include both insurers known in past transactions (*e.g.*, Zurich, Ace, XL, Chubb, Chartis [AIG]), and new entrants (CV Staff, Great American, Ironshore, Navigators, Arch, Liberty, Hudson, Starr Indemnity, *et al.*). Also, instead of paying a one-time premium when the policy is issued, the costs of insurance can be financed over time.

Moreover, with more carriers there is increased competition, with downward pressure on premiums, particularly when compared to a couple of years ago. Policyholders still need to be careful. The Recession, the AIG situation, the increasing number of “markets,” major bankruptcies, and regulatory programs requiring financial assurances, all raise a concern about the financial strength of individual insurers. Insurance providers that score A- or higher by A.M. Best are considered stable. The net result of increased competition is more environmental insurance is available, from stronger insurance providers, with better pricing and coverage.¹⁵

¹² Also known as premises legal liability ("PPL") or environmental impairment liability ("EIL") insurance.

¹³ There are also contractors and owner controlled insurance programs, as well as surety bonds and representations and warranties blended with insurance.

¹⁴ The U.S. Environmental Protection Agency currently is in rulemaking that includes financial assurance requirements for such activities as hard rock mining, chemical manufacturing, petroleum/coal production, electrical energy generation and transmission/distribution, and phosphorus mining/fertilizer operations. Currently over \$3 billion in financial assurance is posted annually in the US. In the past, over 55% of this financial assurance has been met through financial test demonstrations or corporate guarantees.

¹⁵ The competition has reportedly resulted in a 20% to 50% reduction in premiums since 2007, several carriers offering combined general liability and pollution coverage, and a focus on risk-based corrective action in cleanups. Policies can be more tailored, as to industries (*e.g.*, mining and healthcare), as to contractor’s pollution liability, non-owned disposal sites, “sick building” diseases (*e.g.*, mold, Legionella, *etc.*), business interruption costs, and damages (and penalties, where allowed by law).

Remediation cost cap insurance is still more limited than the other forms of environmental insurance. The underwriting departments of the insurance carriers use modeling to determine the policy limits (and the premium). This type of insurance will include an "attachment point" as to when such things as newly found contamination will be covered. The insurance carriers in the past set the "attachment point" at the point set by the policyholders' environmental consultant.

Today, the carriers' underwriters review the plan itself and the experience their own environmental consultant specialists have had with regulatory oversight. Because of the detail and complexities of the potential cleanup liabilities of some properties, the carriers may charge underwriting costs, such as environmental consultant evaluations, to those who are seeking insurance coverage. On the other hand, one of the beneficial results for policyholders is that coverage for change orders, as they occur, is more available.¹⁶

B. Other Risk Allocation Methods in Purchase/Sale Matters

Aside from insurance, there is a renewed focus on traditional methods of risk management in real estate transactions. Because the pace of commercial transactions is not what it was in the recent past, real property buyers and sellers are paying close attention to the environmental condition of the real property in their purchase and sale transactions.

Valuable information as to managing environmental hazards is found in Chapter 5E, §§5:181 - 5:248, "Addressing Environmental Hazards Liability Concerns of Real Property Buyers and Sellers," California Practice Guide: Real Property Transactions (Greenwald & Asimow, Rutter/Westlaw).

The methods to manage such risks include:

- Environmental investigations and "baselines"
- Seller's escrow deposit
- Delay closing under remediation is completed
- Restructure transaction, e.g.,
 - change purchase and sale to lease with option to purchase
 - Divide surface estate from subsurface estate, long term ground lease on surface
- Allocate risks contractually
 - Environmental indemnities
 - Releases -- Remember Civil Code §1542 waiver
 - "As is" clauses -- §§5:223-5:226.
- Prospective purchaser agreements

¹⁶ Based on James R. Arnold, "2010 Update: Insurance for Environmental Transactions and Brownfields," published by the American Bar Association's Environmental Transactions and Brownfields Committee of the Section of Environment, Energy, and Environmental Law.

- Record notice of environmental condition and/or remediation against title
- Record institutional controls (e.g., covenant running with land, restrictive easement, etc.)

C. Landlord/Tenant Issues

One reason that landlords have challenges with CERCLA is that they are considered "owners" even though they lack day to day operational control over their tenant's activities. And, because it is difficult to prove when an actual release or disposal occurred, the current owner/landlord may face a disproportionate share of environmental cleanup liabilities.

Landlord/owners have faced CERCLA liability in many cases. See, e.g., *Lincoln Properties, Ltd. v. Higgins*, 823 F.Supp. 1528, 1533 (ED Cal 1992); *US v Stringfellow*, 661 F.Supp. 1053, 1063 (CD Cal 1987). But, tenants can also face liability as "owners," and will be subject to claims by plaintiffs because proofs of when actual releases or exposures occurred --and by whom, are often very difficult and expensive.

The seminal decision has been *Commander Oil Corp. v. Barlo Equip. Corp.* 215 F.3d 321 (2d Cir. 2000). The Second Circuit considered whether a subtenant should be considered an "owner" and identified five characteristics of a tenant as an "owner."

- (1) whether the lease is for an extensive term and admits of no rights in the owner/lessor to determine how the property is used;
- (2) whether the lease cannot be terminated by the owner before it expires by its terms;
- (3) whether the lessee has the right to sublet all or some of the property without notifying the owner;
- (4) whether the lessee is responsible for payment of all taxes, assessments, insurance, and operation and maintenance costs; and
- (5) whether the lessee is responsible for making all structural and other repairs.

Although the Second Circuit found the subtenant in *Commander Oil* was not an "owner," this test for determining whether non-owners should be considered CERCLA "owners" has found some acceptance. In *Servco Pac. Inc. v. Dods* 193 F.Supp.2d 1183 (D Haw 2002), a tenant with a 50 year lease was deemed an "owner." In *Pateley Associates I, LLC v. Pitney Bowes, Inc.*, 704 F.Supp.2d 140 (D Conn 2010) the defendant with a "hell and high water bond net lease" that arose from a sale-leaseback arrangement was deemed an "owner."

But in *City of Los Angeles v. San Pedro Boat Works*, 635 F.3d 440 (9th Cir. 2011), the Ninth Circuit rejected what it called "...tests which do not clearly call out what an investor in land can expect and which factors are themselves susceptible to endless manipulation in

litigation..." and said it would follow *Long Beach Unified Sch. Dist. v. Dorothy B. Godwin Cal. Living Trust*, 32 F.3d 1364, 1368 (9th Cir.1994) (easement holder not "owner" under CERCLA) and look to the common law to determine whether a non-owner should be considered an owner. The courts will follow a State's common law as to the definitions of property interests, particularly those such as "owner" and "operator," etc., under CERCLA and HSAA.¹⁷

These decisions suggest that tenants should conduct their own "due diligence" before leasing commercial property -- and landlords should monitor the activities of their tenants to avoid contamination.

III. Conclusion

Environmental law in California will continue to require diligence -- of every sort, and energy on the part of owners, sellers, buyers, landlords and tenants.

¹⁷ As the Ninth Circuit explained in *Redevelopment Agency of City of Stockton v. BNSF Ry. Co.*, 643 F.3d 668, 680 (9th Cir. 2011)(decided since the May 2011 "Real Estate Retreat," the law is that an easement owner is not an "owner" under CERCLA, and an easement owner is not an "operator" under CERCLA unless it conducts operations related to the contamination (rejecting liability for a railroad with an easement for a buried drain installed to improve soil stability, after oil from an offsite source was found in the drain) In the landlord/tenant context, of course, lease terms may alter this developing rule as to non-liability of a tenant for pollution. For example, and depending on the language of a lease, a tenant might argue that pollutant spills conducted under property by buried drains the tenant installed are not related to the tenant's use of the property, and the drain was not installed for any purpose related to the contamination. In such a case, the landlord could be found to have sole liability.