AXA XL Insurance

Environmental risk bulletin

Property Transactions and Environmental Due Diligence

Acquisition of new real estate, whether a developed or undeveloped property, donated or inherited, brings the potential for environmental risk. Present day operations and use may not reflect any obvious historic environmental risks at a property. When it comes to business deals, nobody likes surprises. Property buyers, sellers, lenders, developers and even individuals being gifted real estate can all benefit from performing environmental due diligence prior to a transaction.

Transaction due diligence typically involves engaging an experienced consultant to conduct a Phase I Environmental Site Assessment (ESA) in accordance with published standards. This process establishes a standard of care that is recognized by regulators and business partners and considered an essential risk management step. The intent of this bulletin is to provide an overview of the Phase I ESA process, benefits & pitfalls, environmental due diligence programs, and other risk management considerations for property acquisition stakeholder.

A Phase I ESA is referenced as such because it may only represent the first step in property acquisition due diligence. Subsequently, a Phase II ESA or limited site investigation may need to be performed to address unknowns and confirm the presence or absence of site contamination. A Phase II ESA typically involves subsurface investigations with soil, soil gas, and groundwater sampling methods that go beyond a Phase I ESA and the scope of this bulletin.

Background

In the United States, the federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) addressed responsibility for the cleanup of sites contaminated with hazardous substances. Under CERCLA, any party that purchases a property with unknown environmental impacts or concerns is responsible, through strict, joint and several liability, to address contamination in accordance with applicable regulatory requirements even if they did not create the pollution.

CERCLA also includes an “innocent landowner defense” provision for any property with environmental liabilities that existed prior to the purchaser’s ownership or involvement with the property. Successful use of this legal defense requires the purchaser to make “all appropriate inquiries into the previous ownership and uses of the property consistent with good commercial or customary practice” to identify material threats to the environment. The Small Business Liability Relief and Brownfields Revitalization Act included additional clarification on available CERCLA liability protections such as contiguous property owners and bona fide prospective purchasers. Application of these liability exemptions typically involves legal counsel, but a quality Phase I ESA is the cornerstone.

USEPA defines what constitutes All Appropriate Inquiry in 40 CFR 300 (National Oil and Hazardous Substances Pollution Contingency Plan) and cross-references ASTM International (ASTM) standards and other protocols to ensure compliance. The level of appropriate inquiry can vary according to the purchaser, lending institution requirements, and type of property. Failure to perform adequate due diligence can result in long term liability and claims related to property damage, bodily injury, and remediation while also incurring significant legal defense expense.

In Canada, there are different federal and provincial laws and regulations driving environmental due diligence and site assessments. The Canadian Standards Association (CSA) has also developed standards to assist individuals with making informed decisions concerning potentially contaminated sites. CSA outlines similar protocols to ASTM. They note that the ASTM E1527-21 Phase I ESA standard discussed at length below was an important source for CSA in developing guidance for planning, implementing, and interpreting Phase I ESAs.

Due diligence and risk management

There are many drivers for conducting a Phase I ESA on a property beyond regulatory compliance. Transactional due diligence can involve other types of assessments in addition to a Phase I ESA. For example, if a buyer intends to continue site operations, they may elect to have an environmental, health and safety audit performed to identify significant noncompliances and associated costs. Similarly, a buyer that is concerned about the useful life of buildings and other assets may elect to have a property condition assessment performed to supplement an appraisal.

An ESA should be viewed as a risk management tool that complements purchase and sale agreement language and insurance requirements. Sellers want to define and minimize any long-term environmental liability or obligations. Buyers do not want to be surprised by unknown pollution conditions and unbudgeted expenses. Financial institutions have a vested interested in ensuring a loan holder will not encounter significant environmental issues that result in customer bankruptcy, loan default or a property owner walking away from their regulatory responsibilities.

Lessees and lessors may also want to evaluate the environmental condition of a property prior to signing a lease agreement and at the conclusion of the lease term. This can be done to establish an environmental baseline that protects both parties from past environmental liabilities and future impacts. Additionally, the lease holder may want to ensure that employees working at the site are not exposed to existing health risks associated with historic contamination. Landlords and tenants should not rely on pollution liability insurance and lease agreement language alone. This is particularly important if a new tenant will be using similar hazardous materials as previous operations that caused, or could have caused, environmental contamination.

Surprises and mistakes

From a transaction perspective, real estate stakeholders have an interest in defining known pollution conditions that can impact the value or planned use of a property. Buyers and sellers would never consider skipping a formal property appraisal to determine an appropriate sale value. However, the location, current use, proposed future use, or speed of a business deal can cloud judgement and diminish the perceived need for a quality Phase I ESA.

> For example, a real estate firm was involved in an expedited transaction to purchase a light industrial property for redevelopment as a new warehouse for an existing customer. Although, a Phase I ESA was performed that identified concerns related to a former UST and an abandoned monitoring well, a rushed database and historic records review failed to identify historic vehicle maintenance and parts washing with chlorinated solvents as a potential environmental concern. Soon after acquiring the site and obtaining pollution liability insurance, the site owner discovered extensive soil and groundwater contamination during building demolition and site grading for the new warehouse. This oversight resulted in $800,000 in unexpected remediation expense.

Nobody likes surprises during a property transaction, but there are many cases where inadequate due diligence has resulted in unexpected long-term liabilities, regulatory obligations, and expenses that threatened both profitability and intended use of a site. Also, even when a Phase I ESA is conducted, mistakes can be made, and significant environmental conditions overlooked. Unknown underground features can be missed, important areas of a site may be inaccessible, site history and other data gaps may be unclear, and/or recommendations for further investigation ignored or dismissed. This reality underscores the importance of selecting and retaining an experienced environmental consulting firm with adequate professional liability insurance coverage. Consulting contracts and project scopes should be reviewed by legal counsel and risk management staff.

Historic uses and unexpected problems

Former industrial sites or “brownfield” properties proposed for redevelopment can have clear environmental concerns, but some current and historic site uses might be more subtle. Even undeveloped sites can have risk. Properties previously used for farming, orchards and other agricultural purposes may have impacts from long-term use of pesticides, herbicides, and fertilizers.

A parking lot may have been part of a former manufacturing area with uninvestigated contamination. Perhaps the property did undergo previous investigation and remediation but is now subject to expensive engineering controls to contain and/or treat groundwater. Perhaps the site has been used as a parking lot for many years because it is subject to institutional controls that

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prohibit redevelopment for commercial or industrial use. Sites whether owned or leased can have unknown environmental histories. Just a single tenant over a long leasing history at any commercial, retail, warehouse or industrial property can cause significant, undisclosed contamination. Activities such as dry cleaning, vehicle maintenance, wastewater/septic discharges, and outdoor hazardous material/waste storage can impact a site over a short period.

Buyers and sellers can't disregard environmental problems from their neighbors during a transaction either. Adjacent and upgradient sites can sometimes present an even greater exposure. Nearby sites can be the source of polluted stormwater runoff, groundwater contamination, leaking USTs, or vapor intrusion risks that a new site owner may become obligated to address in the near term. These risks can threaten the intended use of a site, even while a new owner pursues litigation against the responsible party.

What is and what should never be? Even sites that have undergone a previous environmental assessment may have new liabilities develop because of changing regulatory standards, investigation requirements, and emerging chemicals. Phase I ESAs must evaluate historic operations and impacts relative to current day regulations and best practices. Cleanup standards can change, new pollutants can become regulated, and contamination reporting obligations may be required prior to subsurface work or redevelopment. A Phase I ESA can uncover new concerns and environmental requirements prior to purchasing or accepting a property. This can help minimize environmental liabilities and costs for prospective landowners if they are proactively addressed in a purchase & sale agreement.

Phase I ESA standards

ASTM International is an organization that publishes global standards and guidance including those for environmental site investigations. ASTM E1527-21 "Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process," outlines the investigation process to identify the confirmed presence, likely presence, or a material threat of the presence of hazardous substances or petroleum products at a real property.

Similarly, the Canadian Standards Association (CSA) published CSA Z768- 01 (R2022) "Phase I Environmental Site Assessment" that outlines a very similar process for performing environmental due diligence on properties in Canada. Both the ASTM and CSA standards are periodically updated or reaffirmed.

Other associations, lending institutions, and state/provincial regulatory agencies may have supplemental protocols and formats for environmental site assessments. Some of these requirements are authorized by specific laws and codified regulations (i.e., New Jersey's Industrial Site Recovery Act, Ontario's Environmental Protection Act, etc.)

It should be noted that the ASTM standard limits a Phase I ESA shelf life to 180 days prior to property acquisition or up to one year if certain updates are completed. Older Phase I ESAs are often still relied upon for certain purposes, but users assume more risk of changing environmental conditions. This is particularly the case when a site has more complex industrial operations or high tenant turnover. Environmental conditions can change rapidly and quickly impact assessment findings and development plans.

Phase I ESA scopes, objectives, and conclusions

A Phase I ESA is required to include a description of current site use, physical setting including surrounding property use, a site inspection, historic records review, and interviews with owners/occupants and regulatory officials. The report is required to identify findings and conclusions regarding the environmental condition of the site.

The ASTM Phase I ESA standard requires the identification of Recognized Environmental Conditions (RECs), Historic RECs (HRECs), and Controlled RECs (CRECs), which are defined as follows:

- **REC -** The presence of hazardous substances or petroleum products in, on or at the subject property due to a release to the environment; the likely presence of hazardous substances or petroleum products in, on or at the subject property due to a release or likely release to the environment; or the presence of hazardous substances or petroleum products in, on or at the subject property under conditions that pose a material threat** of a future release to the environment. RECs often result in further investigation being recommended in the form of a Phase II ESA.

- **CREC -** a recognized environmental condition affecting the subject property that has been addressed to the satisfaction of the applicable regulatory authority or authorities with hazardous substances or petroleum products allowed to remain in place subject to implementation of controls (i.e., activity and use limitations or other property use limitations). Note this can include required engineering controls (i.e., remedial systems) or institutional controls (i.e.., deed notices and restrictions).

- **HREC -** A previous release of hazardous substances or petroleum products affecting the subject property that has been addressed to the satisfaction of the applicable regulatory authority or authorities and meeting unrestricted use criteria established by the applicable regulatory authority or authorities, without subjecting the property to any controls.

**material threat - ASTM defines this as an "obvious threat which is likely to lead to a release and that in the opinion of the environmental professional, would likely result in impact to public health or the environment. An example might include an aboveground storage tank system that contains a hazardous substance and which shows evidence of damage. The damage would represent a material threat if it were deemed serious enough that it may cause or contribute to tank integrity failure with a release of contents to the environment."

During preparation of the ASTM 1527-21 revision, the responsible subcommittee provided some additional practical guidance for preparers and users of Phase I ESAs to help frame the above REC definition. They noted that when considering whether an issue should be classified as a REC, the preparer should utilize professional experience to address the question of whether environmental contamination is likely to be found if a subsurface investigation were performed. In other words, if there is enough reason to believe contamination could be discovered, the environmental professional should probably identify the issue as a REC. This might be the case, for example, if a drycleaner or gas station previously operated on a site. Even without historical records of a spill or release, operations like these have commonly been associated with finding contamination when subject to an investigation.

The CSA Phase I ESA standard is not quite as prescriptive with terminology, but it has a similar purpose in identifying "actual" and "potential" site contamination. Generally, this standard explains that the report is intended to reduce uncertainty about potential environmental liabilities and may be the basis for further site investigation. CSA notes that Phase I ESAs can be used to make informed property transaction decisions, identify baseline environmental conditions, assist in meeting regulatory requirements, and serve as an initial step in site remediation. Conclusions are required to discuss evidence of actual contamination, potential contamination, or lack thereof.

De minimis conditions, business environmental risks, and recommendations

ASTM also defines a couple other important terms representing environmental conditions and risks at a property. These issues are often mentioned as findings throughout a Phase I ESA report or presented in specific report sections with general observations or recommendations.

A "de minimis condition" is an issue related to a release that generally does not present a threat to human health or the environment and generally would not be the subject of enforcement action if brought to the attention of appropriate regulatory agencies. A de minimis condition does not require any action and is not considered a REC or CREC. However, minor issues if left unresolved or allowed to continue have the potential to eventually result in a more extensive environmental condition or risk.

A "business environmental risk" (BER) is an issue that can have a material environmental impact (or environmentally-driven impact) on the business associated with the current or planned

use of a property, but not related to those issues required to be investigated under the ASTM standard. BERs can include the "Non-Scope Considerations" outlined in the standard and may be identified based on the discretion of the qualified consultant, or if requested by the customer. Examples of BERs/Non-Scope Considerations include emerging contaminants, asbestos, lead-based paint, mold, radon gas, wetlands, drinking water quality, and PCB building materials.

Some Phase I ESAs will include consultant recommendations; however, there is no requirement to do so beyond a discussion of the above defined terms, related opinions and supporting rationale. In fact, consultants can be subject to additional professional liability when unsubstantiated opinions are provided and/or recommendations are not implemented. Phase I ESA report findings should clearly distinguish facts from opinions. They should also be clear whether the identification of BERs and/or assessment of Non-Scope Considerations are included in the formal project scope of work (e.g., customer/user proposal).

Developing and implementing due diligence programs

It is a good practice for companies to develop a written due diligence policy for distribution to key personnel within the organization. The policy should include, but not be limited to, the following:

- Company policy on property acquisitions/acceptance.
- Designate personnel involved in the property acquisition or acceptance process. The staff within the company responsible for purchasing or accepting properties should be knowledgeable of environmental issues.
- Identify outside consultants and legal counsel that may be involved in environmental due diligence
- Outline the procedures for obtaining, reviewing, and completing environmental site assessments and other transactional assessments
- Outline timelines and milestones in the due diligence and Phase I ESA process
- Establish responsibilities for addressing RECs, CRECs, HRECs, and BERs (and any recommendations)
- Identify other risk management tools and alternatives (i.e., pollution liability insurance and purchase & sale agreement environmental indemnification)
- Develop procedures for approving or rejecting the purchase/acceptance of a property based on report findings and other risk management controls.

Before engaging an environmental professional to perform a Phase I ESA, a business case must be established for acquiring the site. For mergers & acquisitions this can include the review of financial statements, known/pending litigation, and business plans.

Parties engaging in preliminary due diligence to support an acquisition or company merger may wish to perform a precursory environmental screening to identify sites that warrant more intense scrutiny. If the transaction will proceed, organizations are well advised to start this process early and allow adequate time for completion of a quality Phase I ESA and other risk management efforts.

It should be noted that ASTM has developed the Standard Practice for Limited Environmental Due Diligence: Transaction Screen Process (ASTM E1528-22) to address similar, potential environmental concerns as those identified via the ASTM E 1527-21 standard, but in an abbreviated checklist format. This can be applied on a voluntary basis when completion of a Phase I ESA is initially deemed unnecessary by the user. However, to be clear, the Transaction Screen Process is not intended to satisfy CERCLA liability protections and does not identify RECs. This standard is particularly applicable to undeveloped, residential, or commercial properties, where the environmental risks are perceived to be less likely or severe. The reality, however, is that most formal due diligence programs require the completion of a Phase I ESA for any site – undeveloped or developed – prior to moving forward with sale negotiations.

In addition to in-house expertise, Phase I ESA users should give consideration to using a third party to review and provide comments on environmental reports. This is particularly true if the company does not maintain in-house environmental expertise or general counsel. Third party review can provide a legal perspective or a detailed evaluation of the ESA quality and conclusions. If so authorized, the third party can help address the recommendations and determine if a Phase II ESA should be conducted. It is highly recommended that parties work with legal counsel when Phase I ESA are intended to be used to obtain formal regulatory liability protections and/or transactions are sensitive/confidential enough to warrant completion under attorney-client privilege.

Finally, a decision must then be made on whether to purchase or accept the parcel. Going beyond adjustments to property sale price, environmental concerns can be addressed through other

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risk transfer mechanisms such as requirements for obtaining pollution liability insurance. Purchase & sale agreements can also be structured to include environmental indemnification language, clarifying existing engineering and institutional control obligations, establishing pollution discovery periods, and creating escrow accounts to cover any investigation or remediation activities.

Conclusion

Companies acquiring real estate can significantly reduce their environmental liability by implementing a sound due diligence program that relies on environmental professionals. This should include conformance to standards prescribed by ASTM, CSA and other good commercial and customary real estate acquisition practices. These standards are designed to identify actual or potential contamination, material threats, and recognized environmental conditions associated with hazardous substances and petroleum products. Phase I ESA scopes may also include the evaluation of other business environmental risks.

Many critical business decisions essential to the success of a real estate transaction can rest on the conclusions of a Phase I ESA. Far too often reports that utilize non-standard terminology, lack required information, or fail to provide a solid rational for identifying RECs, BERs, etc. can hinder stakeholder decision making. Retaining an experienced environmental consultant to complete a quality Phase I ESA is an important step. Stakeholders should also be mindful of relying on Phase I ESAs that lack transparency related to risk tolerances or financial materiality factors incorporated at the request of a consultant's client.

Companies without a due diligence program or those skipping the Phase I ESA process have experienced many different types of surprises, mistakes, and problems related to property acquisitions. These often manifest as legal liability and remediation expenses, which can threaten profitability and intended use of a property. Firms involved in routine real estate transactions should have a written program that outlines responsibilities, outside resources, due diligence policies, review of reports, and decision making with regard to findings and recommendations.

A Phase I ESA can identify a variety of environmental conditions - some known, some controlled and some unknown. The identification of recognized environmental conditions at a site often results in the need for additional information or a Phase II ESA to investigate subsurface soil and groundwater. Ultimately, the prospective buyer and seller need to evaluate Phase I ESA conclusions, decide how they will be addressed, and determine if the transaction should proceed.

Pollution liability insurance and sales agreements can be effective risk transfer mechanisms, but completion of a Phase I ESA by an environmental professional is considered an essential environmental risk management tool. A Phase I ESA should be used to complement other due diligence and business planning efforts. The Phase I ESA process and an acknowledgement of findings can provide a level of certainty that allows acquisitions to proceed and be a success.

References

- ASTM E1527-21 - Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process (ansi.org)
- Standard Practice for Limited Environmental Due Diligence: Transaction Screen Process (astm.org)
- Standard Practice for Environmental Site Assessments: Phase II Environmental Site Assessment Process (astm.org)
- Brownfields All Appropriate Inquiries | US EPA
- Z768-01 (R2022) | Product | CSA Group

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Risk engineering information provided by AXA XL's Environmental team
505 Eagleview Boulevard, Suite 100,
Exton, PA 19341

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