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GETTING THE DEAL DONE: The Environmental Perspective

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GETTING THE DEAL DONE:
The Environmental Perspective[1]

The Texas real estate market for environmentally-impaired real estate is seeing a definite upswing. The definition of a "sophisticated" lender or purchaser, who not so long ago were considered "sophisticated" because they avoided environmental issues altogether, seems to be slowly giving way to a definition of sophistication that is premised on the belief that environmental risk, in many cases, can be managed to create value and to encourage real estate transactions.

The reasons for this evolution are many and varied, and often site-specific. The willingness of many parties to go forward possibly can be narrowed to four factors: (1) a better understanding in the lending community of environmental risk, (2) changes in Texas environmental regulatory programs that have fostered more workable risk-based cleanup standards and options, typically resulting in lower costs, (3) court decisions creating more predictability in the management of environmental risks in a real estate market, and (4) more creative transactional/contractual options, including evolving insurance products and markets, for experienced environmental counsel.

Following a brief introduction to basic principles of environmental liability, this presentation is divided into four sections, addressing each of the foregoing areas. It is written from the perspective of an environmental lawyer who works with and therefore has greater sensitivity to the environmental risks that those not in this specialized field regularly encounter. The author acknowledges that those more familiar with the real estate market than the environmental issues that may impact portions of it may tend to view environmental issues with greater concern. The purpose of this presentation, therefore, is not to denigrate those well founded concerns, but rather to provide assurance that when environmental issues arise, they can be addressed and resolved in the right circumstances, consistent with client business needs.

I. Introduction: Environmental Liability in the Real Estate and Real Estate Lending Contexts

Environmental legal liability has been in place for hundreds of years. Common law liability for adverse conditions on real estate, or which migrated from one parcel to another, dates back several centuries to England where causes of action sounding in negligence, trespass to land and other fault-based legal and equitable theories were enforced. Protection of water courses and of real property from flooding has been an important legal and equitable rights for centuries.

[1] This presentation is not intended as legal advice and should not be relied upon as such. Competent legal counsel should be engaged to provide advice concerning specific issues discussed herein and concerning specific real estate and real estate lending transactions.

These common law rights continue to have their place in Texas today and are recognized by the judicial system. Our laws today recognize the natural resources that have been protected for centuries, and require their protection. In one sense, it is the definition or nature of what environmental rights are protectable and the remedies for violation of those rights that has changed. They also recognize and protect the environment in new and different ways: endangered species habitats, wetlands, archeological resources, to name but a few. Man-made chemicals and pollution have expanded the threat to natural resources in ways not previously occurring. Society has the technical capability to address and to remediate most of them.

Most environmental lawyers consider modern environmental law to have begun in the early 1970's, both on the federal and state levels. These laws began to have their impact on the real estate market in the early and mid-1980's, with the passage 1980 of the Comprehensive Environmental Response, Compensation and Liability Act, as amended in 1986 by the Superfund Amendments and Reauthorization Act ("Superfund" or "CERCLA").[2] The Resource Conservation and Recovery Act, as amended,[3] further impacted the real estate market. The amendment of the Texas Solid Waste Disposal Act ("TSWDA") in 1985[4] to create the Texas Superfund Program and Texas provisions pertaining to active management of chemicals and disposal of wastes, round out what today's environmental practitioners consider to be the heart of the environmental regime facing prospective real estate sellers, purchasers and lenders in Texas.

The fundamental difference that these laws, and others, bring to the real estate market concerns their liability scheme: where adverse environmental conditions are present, liability is not fault-based as in common law. It is strict, and it is joint and several. It is based on one's status in relation to real estate or activities associated with real estate. Except for certain special status owners, the current owner of fee title, or less then fee title in some cases, of an environmentally-impacted real property is responsible for adverse environmental conditions on that property and those conditions, if any, migrating from that property, to the full extent of the law. Those who are deemed "operators" on the real property and contribute to the adverse environmental condition are also strictly liable, jointly and severally with the property owner.

This strict liability applies to the owner and operator of a parcel of land, whether or not either of them had anything whatsoever to do with the presence of the offending environmental conditions, or whether those conditions even originated on their property. The same strict liability scheme applies to owners of the real estate from the time the adverse environmental conditions were created on that real estate, and can in many circumstances apply to all operators at the property.

Liability is allocated among owners and operators under federal law based on equitable principles of contribution, and in Texas under the criteria found in the TSWDA,[5] <u>Bonnie Blue et al v. Reichenstein et al.,</u>[6] The purchaser of the real property takes on this liability scheme and its obligations to the government at closing, irrespective of the contractual terms.

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[2] 42 U.S.C. 9601 *et seq*.
[3] 42 U.S.C. 6901 *et seq*.
[4] Tex. Health & Safety Code, ch. 361.
[5] Tex. Health & Safety Code, §361.343.
[6] 127 S.W.3d 366 (Tex.App.-Dallas 2004, no writ).

The courts, Congress and the Texas legislature, as well as the environmental regulatory agencies have considered what real estate "ownership" is sufficient to impose Superfund and TSWDA liability. Whether the ownership of less than fee title to real estate, for example, easement, license and lien holders, has been fertile ground for legal actions of various kinds.

The various classes of possible owners of real estate have also been scrutinized and evaluated. Parent corporations of subsidiary real estate owners, shareholders, officers and directors of entities holding title to real property, governmental property owners, fiduciary managers of title to property (for example, executors and bankruptcy and other trustees), and heirs and beneficiaries all have faced Superfund and TSWDA legal and financial exposure and the possibility of strict liability. Some have faired better than others in the legislative and judicial process. The 2002 Small Business Liability and Revitalization Act,[7] created a new class of potentially protected real estate owners; the contiguous property owner and the bona fide prospective purchaser.[8]

While a detailed discussion of these owners and various interests in real estate in Superfund terms is beyond the scope of this presentation, suffice it to state that all who come in contact with title to real property having adverse environmental conditions should have a sense of awareness and a healthy respect for the management of environmental risk.

II. Secured Lenders

The understanding of federal and state environmental legal and financial risks faced by secured real estate lenders in Texas today, is very uneven. Apart from the relatively few, though growing opportunities most lenders have to encounter and work with environmentally-impacted real estate, this unevenness has its roots in the changes in lender liability over time under Superfund, and to the fact that lender protections under Texas Superfund law were not enacted until 1997.[9]

Lender liability under Superfund and the TSWDA focuses on whether the lender should be deemed either an "owner" or an "operator" with respect to its secured collateral. It is clear in Texas and in all other states that a lender's secured interest in real estate constitutes some indicia of ownership. When a lender forecloses, it is clear that it acquires a greater real estate interest.

Superfund has long carved out an exception from liability for lenders who make a secured real estate loan. In its definition of "owner," there is an exception for persons or entities who, "without participating in the management of [the collateralized property], holds indicia of ownership primarily to protect his security interest in the [real property]." (emphasis supplied).[10]

The early difficulty for lenders with this exclusion had been the narrow interpretation by the environmental regulatory agencies and the Courts of the phrase "without participating in the

[7] Pub. L. No. 107-118 (January 11, 2002).
[8] 42 U.S.C. 9607 (q) and (r).
[9] Tex. Health & Safety Code §§361.271 (f) and 361.701 *et seq.*
[10] 42 U.S.C. 9601(20).

management." The fundamental financial relationship of creditor and borrower inevitably contained some connection with the property in question. The secured loan provides funds for associated with the property and its management. The specter of lender Superfund exposure typically arises where its borrower has run into financial difficulty or, for whatever reason, is unable or unwilling to address adverse environmental conditions on the secured property.

In several Court decisions around the country in the 1980's and early 1990's, lenders' worst fears were realized. In United States v. Mirabile,[11] one of two lenders was found to have participated in the operation of the property, though no foreclosure had occurred, and thus was deemed an operator of the property with full Superfund legal exposure. Things got tougher for the lending community after Mirabile before they got better.

In United States v. Fleet Factors Corp.,[12] the Court imposed Superfund liability on the lender for having participated in activities that placed it in the position of being able to dictate whether and to what extent the borrower could financially address its environmental exposures. The imposition of liability on the lender in this case sent a chill through the lending community. It struck at the heart of the creditor-borrower relationship: there was very little a creditor could do to protect its financial interests without taking the serious risk of incurring Superfund liability in the process. Cases like United States v. Maryland Bank and Trust Co.,[13] had already confirmed that a lender took on Superfund liability once it foreclosed and took title to environmentally-impacted real estate.

These Court decisions, many environmental practitioners believe, were the nadir of the lending community's relationship with Superfund and its environmental liability scheme. The courts, in the name of finding a "deep pocket" to address adverse environmental conditions, had managed to so substantially chill institutional and most other types of secured lending to environmentally-impacted real estate that a political cure was needed. Some in the lending community with especially long memories have not been able to leave this era behind, despite changes in federal and state law.

In the mid-1990's, the pendulum began to swing the other direction. The U.S. Environmental Protection Agency ("EPA") began an evolution in 1992 on the federal level toward a narrowing of secured lender liability for environmental issues impairing their collateral. Some would say that political pressure from the real estate community left the agency with no choice but to attempt to strike a balance between the remedial goals of Superfund and the need for fewer governmental fiscal constraints on the real estate market.

In EPA's so-called Lender Liability Rule,[14] the government focused on the "participation in management" again. It provided lenders some latitude in foreclosure situations and a bit more latitude in pre-foreclosure situations. Lenders' exposure was reduced but not eliminated. Essentially, foreclosing lenders that did not operate the collateral but instead took reasonable commercial steps to market it, had the opportunity to claim an exemption from legal liability.

[11] 15 Envtl. L. Rep. 20994 (E.D. Pa. September 4, 1985).
[12] 901 F.2d 1550 (11th Cir. 1990), *cert. denied*, 111 S. Ct. 752 (1991).
[13] 632 F. Supp. 573 (DMd. 1986).
[14] 57 Fed. Reg. 18344 (Apr. 29, 1992), codified at 40 C.F.R. §300.1100.

Some portions of the lending community accepted this guidance; for others, it was no real comfort. Some courts accepted the balance these regulations purported to strike, but enough did not that the real estate community remained skeptical, or more. It was an improvement, but too much uncertainty remained.

Finally, Congress took action in 1996 to provide a "safe haven" for secured lenders in many common situations.[15] Congress defined "participation in management" of real estate in Superfund terms:[16]

(i) the term "participate in management"—

(a) means actually participating in the management or operational affairs of the facility; and

(b) does not include merely having the capacity to influence, or the unexercised right to control, facility operations;

(ii) a person that is a lender and that holds indicia of ownership primarily to protect a security interest in a vessel or facility shall be considered to participate in management only if, while the borrower is still in possession of the vessel or facility encumbered by the security interest, the person –

(a) exercises decision-making control over the environmental compliance related to the vessel or facility, such that the person has undertaken responsibility for the hazardous substance handling or disposal practices related to the vessel or facility; or

(b) exercises control at a level comparable to that of a manager of the vessel or facility, such that the person has assumed or manifested responsibility –

1. for the overall management of the vessel or facility encompassing day-to-day decision-making with respect to environmental compliance; or

2. over all or substantially all of the operational functions (as distinguished from financial or administrative functions) of the vessel or facility other than the function of environmental compliance;

(iii) the term "participate in management" does not include performing an act or failing to act prior to the time at which a security interest is created in a vessel or facility; and

[15] Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996, Title II, Subtitle E of Pub. L. No. 104-208, 110 Stat. 309 (Sept. 20, 1996).
[16] 42 U.S.C. 9601 (20)(F).

(iv) the term “participate in management” does not include –

(a) holding a security interest or abandoning or releasing a security interest;

(b) including in the terms of an extension of credit, or in a contract or security agreement relating to the extension, a covenant, warranty, or other terms or condition that relates to environmental compliance;

(c) monitoring or enforcing the terms and conditions of the extension of credit or security interest;

(d) monitoring or undertaking 1 or more inspections of the vessel or facility;

(e) requiring a response action or other lawful means of addressing the release or threatened release of a hazardous substance in connection with the vessel or facility prior to, during, or on the expiration of the term of the extension of credit;

(f) providing financial or other advice or counseling in an effort to mitigate, prevent, or cure default or diminution in the value of the vessel or facility;

(g) restructuring, renegotiating, or otherwise agreeing to alter the terms and conditions of the extension of credit or security interest, exercising forbearance;

(h) exercising other remedies that may be available under applicable law for the breach of a term or condition of the extension of credit or security agreement; or

(i) conducting a response action under section 9607(d) of this title or under the direction of an on-scene coordinator appointed under the National Contingency Plan, if the actions do not rise to the level of participating in management (within the meaning of clauses (i) and (ii).

In 1997, the Texas legislature first enacted lender liability protections from State Superfund liability.[17] The absence of these protections prior to that time left many Texas lenders and environmental counsel very concerned that the regulatory and statutory changes at the federal level were of limited practical value in Texas. The exposure that Texas lenders may have incurred under Texas statute in their participation or management of their collateral was just as real as under federal law.

The 1997 Texas statutory protections were patterned after the federal statutory changes cited above, though there are important differences, especially in the disposition of foreclosed real property. In Texas, a secured lender is required to sell, re-lease the property, or undertake a

[17] Tex. Health & Safety Code, ch. 361, subch. U.

government-approved cleanup plan within "a commercially reasonable time." A lender is presumed to have divested itself of the property "within a commercial reasonable time" if it advertises the property for sale within 12 months after foreclosure.[18]

Though there is considerable overlap, cautious lenders and their environmental counsel should consider both the lender protections and exposures under federal as well as state law in determining their willingness to enter into any given transaction.

Today, while the lending community still faces challenges with any given environmentally-impaired property, it is far better off today under federal and state law, in the author's judgment, than it has been since Superfund was enacted over 24 years ago. And, as a result, there is more capital available today to the real estate community.

III. Texas Environmental Regulatory Programs

There is no question that actions taken by the Texas legislature and by the Texas Commission on Environmental Quality ("TCEQ") have substantially impacted the real estate transactional community in Texas. Although some of the rights protected by state (and federal) law are still very troubling to the real estate community, protection of endangered species habitat and wetlands, for example, other changes have received widespread acceptance and approval among environmental lawyers involved in the real estate and real estate lending communities.

The current environmental regulatory programs applicable to real estate transactions administered by the TCEQ have shifted since the mid-1990's from an "all-or-nothing" remediation standard to ones that are based on relative risk from given environmental conditions to human health and the environment, based in part on the present and intended future use of the real property in issue. This change has been coupled with the opportunity to obtain certain valuable government assurances of completion of work, of non-liability for selected problems, and other forms of assurances that have inured to the benefit of the real estate community without compromising environmental goals.

The standard approach of early environmental programs in Texas and elsewhere was to address an environmental problem by cleaning it up to the point that one could not detect that the problem had existed. The chemicals were removed to the level that they occurred in nature: to their natural background level. Essentially the approach was to remove all risk associated with the environmental problem that had been created.

While this approach was simple to explain and to appreciate, experience showed that it was very difficult and in some cases impossible, to implement. A variety of factors were at work. In some cases, the technology to return the real property to background conditions was not available. In other cases, the problem had occurred many, many years earlier, and had only recently been discovered. In some cases, the problem had migrated vertically downward into groundwater and/or to other landowner's holdings. There were issues of access to third party property and hesitancy by some property owners or their lenders, or both, to allow testing. In

[18] Tex. Health & Safety Code §§361.702(a)-(c).

some situations, the chemicals involved had interacted with the environment and had been broken down into innocuous other chemicals and could no longer be detected.

In the real estate context, the issue of time was often a serious impediment to remediation to natural background conditions. An environmentally-impaired parcel of real estate might be able to be cleaned up, but not within a time frame consistent with transactional goals.

Moreover, often the cost to return environmentally-impaired real property to actual background conditions was untenable, based on the value of the real estate involved, or by one or more other financial measures. The commonly understood cost benefit model used to handle other types of risks associated with real estate never came into play. Another approach was necessary.

Texas was among the first states to take action. The TCEQ's predecessor agencies created and implemented risk-based regulations. They were, and are generally based on a form of cost/benefit analysis. This form includes not only the perspective of the stakeholders in the real property, but also the perspective of societal economic externalities: the value the community and the state place on environmental resources. The programs are based conservative scientific and epidemiological principles, and are found today in the Texas Risk Reduction Program ("TRRP").[19] This program applies to all type of chemical releases to real property, surface and subsurface water in Texas, regardless of the source of the environmental problem.

There is no question that TRRP as applied in the following programs have had a very important impact on the real estate transactional community in Texas.

A. <u>Voluntary Cleanup Program</u>

In addition to changing the approach in Texas to environmental clean up standards, the TCEQ has created incentives to land owners to approach the state on a voluntary basis to offer to address their environmental-impaired real estate, and real estate to which that impairment may have migrated. While details of the Voluntary Cleanup Program ("VCP"),[20] are beyond the scope of this presentation, there are four elements of particular relevance to the real estate community, including lenders.

1. The applicant has greater freedom to evaluate its environmental situation and to develop the response to it. The TCEQ, while retaining its right to reject applicant plans, is unlikely to impose requirements on the applicant. This can vitally affect cost and timing.

2. Participants in the VCP receive immunity from state legal action associated with the environmental conditions at issue. This is important to the real estate community because there is assurance that the funds available for the environmental problem will be directed to the problem itself, rather than diverted

[19] 30 T.A.C. 350 (2004).
[20] Tex. Health & Safety Code, ch. 361, subch. S.

to a legal dispute. This immunity does not apply to federal government claims or to claims of private landowners.

3. Once the TCEQ is satisfied through the VCP program, it will issue a Certificate of Completion, binding it to the legal conclusion that the site clean up is finished.

4. There is an opportunity for a purchaser of land within the VCP to receive the benefits of the above, regardless of whether the seller or the purchaser, or both, implement the environmental remediation.

The vast majority of environmentally-impaired real estate transactions in Texas involve the VCP program and allocation of the risks and rewards associated with implementation of an environmental response within that context.

B. Innocent Owner/Operator Program

In 1997, the Texas legislature enacted Subchapter V to the Texas Solid Waste Disposal Act, entitled "Immunity from Liability of Innocent Owner or Operator."[21] As a practical matter, this program permits the TCEQ to issue a Certificate that declares that a person is an innocent owner or operator, and therefore not responsible for the environmental problem described in the Certificate.

To qualify for a Certificate, an applicant must establish that their real property has become contaminated as a result of a release or migration of contaminants from a source or sources not located on the property, and that they did not cause or contribute to the source or sources of the problem. The legislation states that the protection is available to a purchaser, "if after appropriate inquiry consistent with good commercial or customary practice, the person did not know or have reason to know of the contamination at the time the person acquired the property."[22] In these circumstances, the state will agree that the owner of one real property is not responsible for an environmental problem on that property that originated on a neighbor's real property.

This program is not legally superfluous, though it is typically true that one real property owner is not responsible for an environmental problem that originates on a neighbor's real property. This program has been found to be of value in demonstrating to third parties: lenders and others, that an independent legal entity has confirmed that the Certificate holder did not cause or contribute to a given environmental problem. This can head off or mitigate adjoining property owner litigation, and assure a prospective lender in a marginal financial transaction.

This program is sometimes confused with the innocent purchaser defense to liability arising under the federal Superfund statute.[23] That defense is far more valuable and far more difficult to obtain. It provides protection against environmental conditions on real property,

[21] Tex. Health & Safety Code §§361.751 *et seq*.
[22] Tex. Health & Safety Code §361.752(b).
[23] 42 U.S.C. 9607 (b)(3) and (b)(35)(A)(i).

irrespective of the source or sources of the adverse conditions, so long as the conditions were not identified after all appropriate inquiry at the time of the transaction.

C. Municipal Setting Designation (MSD)[24]

In 2003, the Texas legislature enacted the MSD program, possibly the most tolerant environmental regulatory risk management tool in Texas. The MSD program is premised on the conclusion that groundwater in some communities is either not worthy of environmental protection because it serves no present or anticipated future purpose for human consumption, or because it is so pervasively polluted and incapable of being remediated to allow human consumption that the expenditure of funds in an effort to do so is not in the public interest. There has been no MSD established in Texas almost one year after the law was enacted. The TCEQ staff has worked on draft regulations but has not initiated formal rulemaking at this time.

If a MSD is granted, a property owner conducting a remediation need not consider or may consider to a lesser extent such groundwater in its environmental remediation plan. This can be critical because addressing potential human consumption of contaminated groundwater is typically the most costly and time consuming portion of the VCP process and creates the greatest degree of uncertainty in addressing environmental impacts at a property. (The legislation does not eliminate the requirement to address environmental impacts to groundwater that are not related to potable water use.)

A municipal setting designation is a specified geographic area that is certified by the TCEQ following an application by a property owner, municipality, or others. The legislation relies on:

1. Institutional controls (for example, city ordinances and deed restrictions) that prohibit potable use of affected groundwater within an MSD; and

2. The absence or elimination of conditions causing or reasonably anticipated to cause offsite impacts to human health within a buffer zone surrounding the MSD.

The steps for obtaining an MSD, as set forth by the legislature, are:

1. File an application with the TCEQ establishing compliance with the eligibility criteria for an MSD.

2. Notify affected municipalities, retail public utilities, and private owners of registered water wells.

3. Demonstrate that the property for which the designation is sought is subject to a municipal ordinance or deed restrictions prohibiting potable uses of affected groundwater.

[24] Tex. Health & Safety Code, Ch. 361, Subchapter W.

4. Obtain a resolution in support of the application from affected municipalities and public utilities.

5. Satisfy TCEQ (after 60-day public comment period) that the application is administratively complete and there are no grounds for denial of the application based on current and future regional water resource needs or obligations.

It remains to be seen whether this program will gain the momentum at the TCEQ envisioned by the legislature when it was enacted, and thus whether it will have a meaningful impact on the real estate market in Texas.

D. Dry Cleaners Program[25]

One of the greatest risks a real estate owner faces is the prospect of a tenant contaminating its property, and then not being financially strong enough to address that problem. When the tenant's contamination is very difficult to clean up and the number of tenants creating these problems is significant, the environment of entire areas can be compromised.

Possibly the single largest environmental problem for Texas land owners meets this description. Dry cleaners are pervasive, leaks from dry cleaners are legend, the chemicals historically used in the industry are very, very problematic to address in the environment, and there are very few dry cleaner owners with the financial means to address the problems their operations have created.

The Texas legislature came up with its own solution in enacting H.B. 1366 in 2003. The law is intended to address what are estimated to be thousands of leaks of dry cleaning fluid from dry cleaners across Texas. This program has the potential to profoundly affect the real property owners where these dry cleaning leaks have occurred, the dry cleaner owners, and the owners of real property to which these leaks may have migrated.

H.B. 1366 provides a program for environmental remediation ("corrective action") relating to dry cleaning solvents at certain sites where dry cleaning is being, or has been, conducted. The corrective action is to be conducted by the TCEQ, rather than by dry cleaners or real property owners. Sites across Texas are to be prioritized according to a site ranking system and based on applications filed to the program.

The corrective action projects are to be paid for out of a TCEQ-administered fund. Funding is to come from state-imposed taxes on dry cleaning chemicals and from per-site licensing fees. The fund, which had raised less than $5 million as of June 2004, is likely to be woefully inadequate for the tasks assigned to it by the legislature.

With certain exceptions, the law imposes new registration, release reporting, dry cleaning solvent purchasing fees, operational requirements, and non-compliance penalties on

[25] Tex. Health & Safety Code, ch. 374.

existing and new dry cleaners. It also imposes a new “no discharge” standard on dry cleaning solvents. A “dry cleaning facility” generally means a retail commercial establishment that operates, or has operated, in whole or in part for the purpose of cleaning garments or other fabrics using a process that involves any use of dry cleaning solvents (e.g. perchloroethylene and petroleum based solvents). “Owner” generally means “a person who owns or leases, or has owned or leased, a dry cleaning facility and who is or has been responsible for the operation of dry cleaning operations at the dry cleaning facility.”

To be eligible for corrective action by TCEQ, a contaminated dry cleaning site must be submitted for ranking by an “Owner” of a dry cleaning facility at the site or a person who is or has been an owner of real estate on which the dry cleaning facility is located for not less than five (5) years as of the date application for the program (i.e. site ranking) is submitted. The purpose for the time requirement was to assure that the program did not unintentionally create a market incentive to sell and buy real property where problems qualifying for state remediation and funding exist.

The legislation provided that disbursements from the dry cleaning facility release fund for corrective action may not begin before January 1, 2005. The TCEQ may not use money from the fund for corrective action in excess of $5 million at a single contaminated dry cleaning site (i.e. based on single zone of contamination rather than according to separate tracts of land). Money from the fund may not be used to compensate third parties for bodily injury or property damage caused by a release of dry cleaning solvents, other than property damage included in a corrective action plan approved by TCEQ.

The TCEQ may not spend money from the fund for corrective action at a site contaminated by solvents normally used in dry cleaning operations if the contamination did not result from the operation of a dry cleaning facility. TCEQ also cannot spend fund money at a site that is not a dry cleaning facility but is contaminated by dry cleaning solvents that were released while being transported to or from a dry cleaning facility by a person other than the Owner of the dry cleaning facility or the Owner’s agents or employees. The TCEQ also may not pay for any costs associated with the payment of a fine or penalty under state or federal law by the Owner of a dry cleaning facility, or for corrective action at a site included on federal and state Superfund listings.

In the short and possibly long term, the most important provisions of this law may be the legal immunities it offers. If an Owner or other person is eligible to have corrective action costs paid by the fund, such persons are not subject to administrative or judicial claims by the state or by any other person, except a political subdivision, under state law to compel corrective action or to seek recovery of the costs of corrective action. This exemption, which protects eligible Owners and property owners, applies only to a cause of action that “accrues” on or after January 1, 2004 and before September 1, 2021.

It is projected that this immunity will (1) provide greater comfort for real estate lenders who can be confident that their borrowers will not face legal claims for these types of problems (and more comfort to those borrowers), and (2) provide less comfort to lenders to those whose real property adjoins these sites (as well as to those owners).

IV. Transactionally-Based Environmental Risk Management Tools

A. The Environmental Realities

Real estate is unique. The adage "location, location, location" means, to the environmental practitioner, that just about every transaction involving environmentally-impacted real property is unique as well.

A real estate seller can not completely be relieved of legal and financial exposure for environmental problems on its property. In the same way, the real estate buyer can not completely avoid legal and financial environmental exposure for the property is acquires. Generally, then both parties have the same incentive: to get the environmental conditions resolved.

B. Isolation of Environmental Liability through Organizational Structure

It is not possible to shift all of a real estate seller's environmental risks to a buyer because the federal (CERCLA) and state (TSWDA) statutory schemes that impose that liability do not terminate at closing. They present a continuing contingent obligation.

Most real estate sellers plan, or ought to have planned, when they acquired their property to isolate the environmental risks by taking title in a single asset entity. Several years ago, it was unclear whether this organizational structure would be recognized and upheld by the courts as a way to isolate legal and environmental exposures. The competing public policy in environmental law favors remediation of environmental problems by those that stand to realize economic gains from real property ownership. Two legal issues have now been addressed, upon which parties now often rely when structuring to acquire real estate:

1. Is the owner, whether a parent corporation or otherwise, of a single asset entity liable for its subsidiary's environmental problems? If the owner of the polluting entity is or might be liable, there would be little value to creating the entity in the first instance.

2. Can the assets of the owners/shareholders of the single asset entity be protected from the legal and financial obligations imposed by environmental law on the single asset entity?

The first question had caused a national split in the U.S. Courts of Appeal. The Fifth Circuit was possibly the most generous of the Circuits in recognizing and protecting the limited exposure of the parent corporation for the environmental problems of its subsidiary. This question was answered definitively under federal law by the U.S. Supreme Court in United States v. Best Foods, Inc.[26]

Though the facts in Best Foods involved a parent and subsidiary relationship (the outcome was that this parent corporation was not liable for the environmental exposures of its subsidiary), this case has a direct bearing on the ability to isolate an environmental liability in a single asset entity. The Court stated that Congress did not create, or intend to create, a separate federal common law for piercing the corporate veil in federal environmental law. Rather, it intended to rely on the policy of individual states when and if the "corporate veil" is to be pierced. If a parent corporation would not be held liable for the liabilities of its subsidiary under a state's piercing the corporate veil theory for a non-environmental law claim, it should not be held liable under those same laws for environmental claims. In effect, this decision can and is often read to mean that if corporate formalities are respected, an environmental liability can and should remains isolated in the entity that incurs that liability.

In addition to validating the single asset entity approach, the message for lenders from this case is that they can focus on the environmental issues of the borrower, with less focus on the environmental liabilities arising from other entities within a common corporate structure.

Best Foods was not decided under Texas law, and therefore there remains at least an academic question whether there is something peculiar to Texas law that could lead to a different outcome under the same or a similar set of facts. Although the environmental bar is not of one mind, the author's view is that a substantial majority would consider the Best Foods reasoning to apply to TSWDA claims because of the similarities in their liability schemes. There has not been a court decision interpreting Texas law on this point, however. Texas common law-based environmental claims, though also not governed by this decision, would seem to follow the same limitations on piercing the corporate veil theory.

As to the second question, federal and Texas courts and government regulators continue to look carefully at the employees and decision makers in closely held single asset entities and their environmental liabilities. Government authorities remain skeptical of single asset entities for the very reason investors prefer them: the insulation of individuals from legal exposures by corporate structure.

Best Foods did not impact the government's view of this issue. Clearly, the individual owner of a business that controls the polluting activities may be deemed an "operator" with individual legal exposure. The owner of the land at the time it was contaminated probably has joint and several legal responsibility as well.

The potential personal exposure of individuals is important for the real estate lending community to consider in the context of personal guarantees. Whether the shareholder/owner of a corporate land owner that takes no part in the business that causes the environmental contamination has individual legal and financial exposure is a more difficult question. Under traditional corporate law, such exposure should be very limited.

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[26] 524 U.S. 51 (1998).

Best Foods addressed parent and subsidiary corporations, where limiting the transfer of liability by limiting the piercing of corporate veil are long standing and nationally recognized. The limited partnership structure was not addressed in this case. The question whether a Texas court would interpret federal or state environmental law to provide the same level of legal protection to general and limited partners in single asset limited partnerships in Texas as it would probably provide for a parent corporation is an interesting and undecided question.

While an in-depth review of the Texas partnership law is beyond the scope of this article, it is probably fair to state that the legal protection of limited partners in a limited partnership is not as clear cut or as long held as the protections historically and generally afforded a parent corporation vis-à-vis the liabilities of its subsidiary. It would seem, however, that since the general partner in the limited partnership structure is empowered to discharge the legal obligations of the limited partnership, including the environmental obligations of the limited partnership, it would be held responsible for a failure to satisfy the same. At a minimum, this situation strongly suggests the use of a corporate general partner. The more difficult question concerns the limited partners in the limited partnership where, under the relevant Limited Partnership Agreement, the limited partners are given rights of management in addition to the right to received distributions. This suggests limited partners' rights should be limited carefully by the Partnership Agreement.

The fact that there are few cases addressing the foregoing situations creates the context for the environmental due diligence process.

C. Environmental Due Diligence

Most in the real estate community today in Texas acknowledge that some form of environmental due diligence is advisable as a practical if not a legal matter. Fewer begin with the end in mind: what goals do we hope to accomplish with this work? Satisfaction of lender requirements, satisfaction of "innocent purchaser" requirements, developing leverage for further negotiations, obtaining insurance, and obtaining Sarbanes-Oxley related information are all common, non-exclusive goals.

The environmental due diligence process actually may begin before the property is marketed.

A related question is whether a seller will conduct pre-marketing environmental due diligence on its own property. In today's era of corporate transparency and, for public companies, Sarbanes-Oxley, a seller should at a minimum take into account its internal evaluation of the real estate in its pre-marketing evaluation.

The author often recommends that a seller conduct its own pre-marketing due diligence. This can aid the seller in its marketing decisions: whether and when to market its property, the purchase price, and the contractual terms upon which it is willing to deal. A seller's pre-marketing environmental due diligence, if strategically shared with a prospective buyer, may settle or mitigate some or all of the buyer's concerns.

This work can be handled using internal resources or by engaging outside assistance: environmental counsel, environmental engineers, or both. In engaging an environmental consultant for this work, the terms of the engagement contract bear special attention.

A downside to seller pre-marketing due diligence may be that it will also broaden the disclosures that it will likely need to make if the seller hopes to shift some legal and financial liability to the buyer.

The seller should consider what information it may have about the property and whether it will be disclosed at the outset. Most sellers have an initial reluctance to make disclosures at the outset out of concern that prospective purchasers will choose to look elsewhere.

This reluctance is often shortsighted. It is fairly clear that a seller in Texas of environmentally-impacted real estate is unlikely to successfully shift legal responsibility for known environmental conditions, unless it makes substantial disclosure concerning them. The principles of conspicuousness associated with express negligence doctrine apply to an attempt to shift responsibility for strict environmental liability.[27] In this case, the indemnification failed for the lack of an explicit description of environmental claims. This case followed Houston Lighting & Power v. Achison, Topeka & Santa Fe Ry.[28] This explicitness is not required uniformly across the country, nor is this explicitness required in the initial marketing of the real property.

Some form of environmental due diligence by real estate purchasers in Texas is almost universal, particularly for transactions of any significant size or for transactions involving reasonably sophisticated lenders. The reasons are several. In the author's judgment, the following are the most important: (a) creating leverage for further negotiation of price, allocation of environmental risks, or other contractual terms, or for terminating the contract, (b) satisfaction of the lender's requirements, (c) preparing for post-closing Sarbanes-Oxley and other corporate transparency obligations, and (d) attempting to establish the innocent owner or operator, or bona fide prospective purchaser, defenses under CERCLA.

There are few industry standards for performing environmental due diligence. Many purchasers began, and often end, with the standards of the subjective innocent owner or operator defense under CERCLA. This requires the buyer to undertake, "at the time of acquisition," "all appropriate inquiry" into the "previous ownership and uses of the property consistent with good commercial or customary practice in an effort to minimize liability, Fina, Inc. v. ARCO."[29] Over time, this has practically translated, at a minimum, to performance of a "Phase I Environmental Site Assessment." This terminology, and the scope of this work, was taken from non-binding guidance no. E 1527-00 of the American Society for Testing and Materials, a standards-setting organization.

A "Phase I ESA" provides only the most basic information, includes no physical testing, and unfortunately is performed at some environmental consulting companies by their most junior professional staff. Therefore, these reports often do not provide sufficient clarity with which to

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[27] 200 F.3d 266 (5th Cir. 2000).
[28] 890 S.W. 2d 455, 458 (Tex. 1994).
[29] 42 U.S.C. 9607 (b)(3) and (b)(35)(A)(i).

meet client goals. When further detail is needed, whether it be for asbestos testing, or outdoor testing of soil, water, or subsurface conditions, more work is necessary. Experienced environmental attorneys may offer counsel to assure that the required level of detail and risk evaluation is obtained. Lenders may engage counsel or consultants at times to assure the requisite analysis is provided to decision makers.

The standard for what constitutes "all appropriate inquiry" under federal law is evolving. Congress passed what is commonly referred to as The Federal Brownfields Law,[30] with the specific goal of creating clarity with respect to the level of due diligence required to qualify for CERCLA's innocent purchaser defense. Indirectly, many predict that this action will create minimum standards across the real estate industry for environmental due diligence.

The law directed the U.S. Environmental Protection Agency to promulgated regulations which when finalized will address many aspects of environmental due diligence. EPA's work to date suggests that environmental due diligence will become broader and more expensive, and will be performed by persons with more than a modicum of background experience in the subject matter. Until EPA has finalized regulations, the law explicitly sanctions the continued use of the ASTM guidance. EPA estimates it will be at least one year and probably longer before the standards of what constitutes "all appropriate inquiry" are modified.

D. <u>Contractual Provisions</u>

1. <u>Representations</u>

Representations concerning the environmental condition of a real property are a significant component of most real estate contracts.

A seller should represent that it has provided all environmental documents, or the documents identified by name on an attached Exhibit to the Contract, so the parties are clear on the disclosures that have been made. This is critical for the seller hoping to shift some legal exposure for the environmental conditions at or migrating from the real property.

It is not uncommon that with this disclosure the seller makes a negative representation concerning the accuracy of any environmental documents provided to the purchaser, and for the buyer to represent that it will not and does not rely on rely on such information. Instead, the purchaser represents that it is relying solely on its own advisors and due diligence.

A representation of "compliance with laws," while useful in some contexts, is typically not adequate to provide disclosure to a sophisticated purchaser. Environmental liabilities and financial exposures may arise after closing from conditions that were not known at closing or which were known and may be compliant with laws and still impose financial exposures, such as personal injury or property damage. Or, adverse conditions may exist, whether or not

[30] 2002 Small Business Liability and Revitalization Act, Pub. L. No. 107-118 (January 11, 2002).

known to the seller that are not violations of a law. While a "compliance with laws" representation is helpful to the purchaser, protections of consequence are derived from far more specific representations.

2. As Is, Where Is

The author has observed many real property sellers relying on "as is, where is" clauses to purportedly shift all environmental responsibilities to the purchaser. In these transactions, the seller believes that a simple, conspicuous "as is, where is" provision is sufficient to transfer all its environmental legal and financial exposure to the buyer. Similarly, some buyers fight "to the death" to avoid accepting such provisions, for fear that they are accepting all of the seller's environmental legal and financial liability. Or, a buyer may negotiate hard for the absence of such a provision, concluding that in its absence, it takes on no environmental responsibility. All of these parties misunderstand the law in Texas to some degree.

"As is, where is" is a general disclaimer of representations and warranties not expressly made in the purchase agreement in Texas. In the environmental context, one may think of the clause applying to the condition of the real property in question. One case in which an "as is where is" clause was found to be quite helpful to a seller was Prudential Insurance Company of America v. Jefferson Associates, 896 S.W.2d 156 (Tex. 1995). In that case, the seller was unaware of the presence of asbestos in its building. The purchaser discovered the asbestos following closing and sued to have seller pay for abatement of the asbestos. The seller successfully defended the claim on the basis of the "as is, where is" clause. The "as is, where is" clause was one of several clauses, however, that addressed the environmental situation of the property, therefore, undue reliance on this case and this clause itself is unwarranted.

The "as is, where is" clause seems to be of little use in Texas standing alone, in relation to the seller's existing environmental liabilities under statute, or in certain instances, its common law liability. More often, claims for environmental remediation expenses and injunctive relief, including affirmative relief requiring a party to conduct an environmental clean up, and are brought under CERCLA or RCRA, and the TSWDA in Texas.

In distinguishing Prudential, the Court of Appeals of Dallas, found in Bonnie Blue[31] held that a purported "as is, where is" clause was not a bar to the imposition of statutory responsibility under under the TSWDA. Under CERCLA, "as is" clauses do not bar claims, International Clinical Lab v. Stevens.[32] As one author has stated, "neither an 'as is' clause, standing alone, nor the seller's

[31] 127 S.W.3d at 369.
[32] 710 F.Supp. 466 (E.D.N.Y. 1989).

ignorance of contamination, will bar a CERCLA based lawsuit for contribution costs."[33]

In addition, contractual protections, such as an "as is, where is" clause in a contract between two parties does not impact the rights of persons not a party to the contract. Such claims are not uncommon in the environmental arena. Statutory claims and common law causes of action, such as negligence, trespass and nuisance may be available to adjacent property owners, tenants and other persons not in the chain of title and not parties to a contract involving that title against the seller of real property, even if its purchaser has accepted that property on an "as is, where is" basis.

3. Indemnification/Release

Contractual indemnifications are often based on the negligence or fault of the indemnitor. It is critical in crafting these types of contractual risk allocation provisions to recall that liability under environmental laws is often strict, and joint and several, not negligence- or fault-based. The failure to expressly identify strict environmental liability is sufficient to reject an indemnification claim based on such liability, Fina, Inc. v. ARCO.[34]

CERCLA contains an explicit provision that states that no indemnification, hold harmless or similar agreement shall be effective to transfer the CERCLA liability of a current owner to a new owner.[35] The law continues that an agreement to insure, hold harmless or indemnify is not barred by law, Id., presumably as to private party claims. Once an entity is a responsible party under CERCLA, it can not shift that exposure through an indemnification agreement. United States v. Lang.[36] The author would anticipate this outcome under the TSWDA, based on the similarity of strict liability schemes.

A contractual release is intended to counter an indemnification. One could fairly anticipate that the same rules for enforceability of an indemnification concerning environmental liabilities would apply to a contractual release.

4. Affirmative Environmental Action

In the event the parties intend that affirmative steps to address a known environmental condition will be taken by one or the other party, detailed contractual language will be necessary. This difficult, detailed drafting is often left to experienced environmental counsel.

These terms should include specifications concerning the Texas regulatory program to be used, and will many times include an agreement concerning the

[33] Timothy Boyce, "As is, Where Is"—Where Are We?"-Jun Probate and Property 26, 28 (May/Jun 1997).
[34] 200 F.3d 266 (5th Cir. 2000).
[35] 42 U.S.C. 9607(e)(1).
[36] 864 F.Supp. 610, 613 (E.D. Tex. 1994).

> remediation standards to be met. If the extent of the contamination is not fully defined, agreement on this subject can be difficult. The source of many post-closing disagreements is contractual language that the remediation will satisfy "government standards." Given today's reliance on risk-based standards, there are often many possible, government-approvable remediation standards, and a failure to specify can be a ready source of contention.

If as is often the case, the remediation standard will include the buyer's recording of a notice in the county deed records concerning residual contamination left at the property by agreement of the TCEQ, this should be negotiated as well.

Reaching a contractual agreement on the financial impact of a plan to address known environmental conditions can be as or more challenging than reaching agreement on the environmental standards that are to be met. This is especially the case when both parties to the transaction are single asset entities. Escrow accounts, third party financial guarantees or other forms of support, including letters of credit and insurance, and other creative mechanisms are all ripe for discussion.

It is critical that any and all environmental provisions expressly survive closing. It is important as well that these provisions explicitly refer to environmental claims and, in many cases, to the environmental conditions and reports in which those conditions are discussed, if a shift in liability is being attempted.

E. <u>Insurance</u>

The environmental insurance market in Texas has evolved to the point that environmental insurance can be an effective risk allocation tool for the parties to the transaction, as well as for the lender. Insurance is most often used in the context of known environmental conditions and an anticipated affirmative environmental action to address those conditions. Policies are available for unknown conditions as well as the less direct financial impacts of environmentally-impaired real estate.

Environmental insurance is not written on common forms or with common endorsements. Rather, each carrier offers its own policy forms and corresponding scopes of coverage. Often, the final scope of coverage has been heavily negotiated. Experienced environmental counsel can guide their client through this insurance maze. The author's experience is that there are few insurance brokers in Texas with the ability and experience to provide highly capable service and guidance in the environmental insurance arena.

The most active insurers in Texas offer forms of environmental insurance that "cap" the financial exposure of the party that shoulders the affirmative environmental action. Self-retained limits are often set at what the insured and the insurer reasonably agree is the anticipated cost for that action.

For the party that does not shoulder the affirmative environmental action, but could be held responsible for it under the strict liability principles of CERCLA or the TSWDA if the performing party fails to discharge its performance obligations, the most common forms of environmental insurance provide a sharing of the financial risk associated with such situations.

Environmental insurance may also address other exposures not covered by Comprehensive General Liability policies, such as on- and off-site claims for personal injury, property and natural resource damages, and economic loss associated with the environmental conditions.

The environmental insurance markets offer products for secured creditors. If a borrower defaults on its environmental obligations <u>and</u> on its Note, this coverage compensates the lender for the lesser of the remaining balance on the Note and the cost of the environmental remediation. Some of these policies require the lender to foreclose to become eligible for the policy's benefits; others do not.

There are gaps in some Corporate Director and Officer policy coverages for environmental claims asserted against the corporation. One should consider the affect of an acquisition of an environmentally-impaired parcel of real property in this context as well.

V. <u>Conclusion</u>

It has been said in some circles that it is not only the known environmental problems that impact the real estate market; it is the unknown issue that creates anxiety. While this is difficult to debate, the confluence of a number of legislative, judicial and market factors has led to an upswing in transactions in Texas involving environmentally-impaired real estate that, in the author's view, is likely to continue.

Although it is too early to predict, the impact of Sarbanes-Oxley and related corporate transparency trends may add to this momentum. Over time, real estate sellers are more likely to have investigated the environmental conditions of their properties and are in a better position to disclose them, purchasers are more likely to investigate and confirm such conditions, and their lenders will become even more familiar with this important segment of the marketplace, facilitating what today may be considered the marginal transaction.

It is the author's hope that this article has provided those in the real estate markets with the assurance that these transactions should not be summarily abandoned, but rather should be approached creatively with the client's business goals in reach.

ABOUT THE AUTHOR

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