

WICHITA BAR ASSOCIATION

“Environmental Due Diligence In Real Estate Transactions: The Innocent Purchaser Defense And The Evolving Standard For Conducting All Appropriate Inquiry”

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Prospective purchasers of real estate have had to contend with a difficult, complex and extremely fact-intensive framework of potential environmental liability under CERCLA. Most experienced real estate investors recognize that CERCLA generally imposes joint and several, strict liability upon a current owner of the property for the cleanup of existing hazardous substance contamination at the property. Once the buyer has acquired some title to the subject property, the buyer falls into the category of a CERCLA § 107(a)(1) “current owner” PRP, with liability for any CERCLA – regulated contamination at the property. In response to this potential for exposure, environmental due diligence has generally become a common pre-closing task in commercial and industrial real property transactions.

One of the chief difficulties practitioners face in carrying out the environmental due diligence task has been the uncertainty as to what constitutes an adequate level of inquiry or due diligence. Some factors fueling this uncertainty include: (a) occasional Congressional changes to relevant sections of CERCLA with differing effective dates, (b) confusing and sometimes contradictory judicial interpretations, (c) heavy dependence on fact specific circumstances making it difficult to come up with workable rules of thumb, (d) varying levels of professional environmental consultant expertise and understanding of the technical and legal implications, and (e) evolving standards and protocols issued by recognized authorities, such as ASTM. In addition, the circumstances of the subject transaction can create additional problems and variables such as (1) closing time pressures, (2) cost, (3) relative local availability of knowledgeable consultants, (4) lender requirements, and (5) seller negotiating posture on environmental reps, warranties and indemnifications, and on pre-closing access to conduct environmental due diligence.

Several recent major developments have arguably established a clearer, more detailed framework for an acceptable due diligence protocol. Those developments are the 2002 Brownfields Act, EPA’s resulting interim guidance and 2005 final rule on “All Appropriate Inquiry”, and ASTM’s development of revised model environmental assessment protocols.

The purpose of this article is to set out the legal parameters for conducting an “all appropriate inquiry”(AAI) within the meaning of CERCLA. Explanation of the AAI concept must include reference to the statutory defenses to CERCLA “current owner” PRP liability, i.e., the Third Party defense, the Innocent Landowner (ILO) defense, as revised, and the relatively new Bona Fide Prospective Purchaser (BFPP) and Contiguous Property Owner (CPO) defenses.

Also briefly mentioned will be some of the trade-offs inherent in utilizing or relying on these latter two new statutory defenses to potential liability.

Discussion of the “all appropriate inquiry” concept should start with an understanding of the basic statutory defenses now available under CERCLA.

I. STATUTORY DEFENSES

A. CERCLA’s 107(b)(3) Third Party Defense.

Section 107(b)(3) of CERCLA provides an affirmative defense to current owner or operator liability. The four elements of the defense are (1) a third party or parties is/are the sole cause of the contamination (i.e., the release of the hazardous substance and resulting damages), (2) the PRP asserting the defense does not have a contractual, employment or agency relationship with the causal third party, (3) the PRP exercised due care concerning the contamination and (4) the PRP took precautions against foreseeable acts and omissions of the causal third party and resulting foreseeable consequences. 42 U.S.C. 9607(b)(3).

This affirmative defense has been available since the enactment of CERCLA. The Third Party defense does not have an express due diligence or “all appropriate inquiry” requirement. However, courts have tended to read into the “due care” and “take precautions” elements a minimal due diligence obligation of sorts. See *United States v. A & N Cleaners & Launderers*, 854 F.Supp. 229, 238-39 (S.D.N.Y. 1994); *United States v. Monsanto Co.*, 858 F.2d 160, 168-69 (4th Cir. 1988) (owner disqualified from relying on the third party defense because it did not inspect the site and failed to discover the occupant’s hazardous substance disposal activities); *Kerr-McGee Chem. Corp. v. Lefton Iron & Metal Co.*, 14 F.3d 321, 324-25 (3rd Cir. 1994) (current owner denied third party defense where it knew about the hazardous substance at time of acquisition and failed to either remove the harmful substances or reduce the threat).

The Section 107(b)(3) Third Party defense has generally received infrequent use by buyers in the context of a real estate purchase due to the disqualifying contractual relation element.

B. SARA 101(35)(A) Innocent Landowner (ILO) Defense.

The 1986 Superfund Amendment and Reauthorization Amendments to CERCLA, popularly referred to as SARA, added the so-called “innocent landowner” or “innocent purchaser” affirmative defense, codified at 42 U.S.C. 9601 (35) (Oct. 1986). The Innocent Landowner defense is a variation of the Section 107(b)(3) Third Party defense that is available notwithstanding a contractual relationship between the PRP asserting the defense and the causal third party.

As originally enacted, the ILO defense required the PRP to prove that it did not know and

had no reason to know that hazardous substances had been disposed of at the property. 42 U.S.C. 9601(35)(A) (Oct. 1986). The “no reason to know” standard required the PRP to undertake “all appropriate inquiry” into the “prior ownership and uses of the property, consistent with good commercial or customary practices.” The term “good commercial or customary practices” is not defined in the statute. Legislative history suggests that “a reasonable inquiry must have been made in all circumstances, in light of best business and land transfer principles.” H.R. Conf. Rep. No. 962, 99th Cong., 2d Sess., at 187 (1986). The statute expressly sets out five (5) mandatory factors to consider in determining whether the “all appropriate inquiry” was satisfied: (1) specialized knowledge or experience of the PRP, (2) relationship of the actual purchase price to the value if uncontaminated, (3) commonly known or reasonably ascertainable information about the property, (4) obviousness of the contamination, and (5) whether contamination could be detected by an appropriate inspection. 42 U.S.C. 9601(35)(B) (Oct. 1986).

For a recent local example illustrating the denial of ILO defense due to the purchaser’s pre-purchase awareness of hazardous substances, see *City of Wichita v. Trustees of the APCO Oil Corp. Liquid Trust, et al*, 306 F. Supp.2d 1040, 1052 (D. Kan.) (2003) (“since the City stipulated it had actual knowledge of TCE contamination at the Bus Barn prior to purchase, the City cannot maintain an innocent landowner defense”).

The “all appropriate inquiry” requirement under the original ILO defense has necessarily become a case-by-case determination, since it is highly dependent on the specific facts and circumstances of the property, the PRP, the local custom, and the nature of the contamination. The AAI is to be measured at the time of the PRP’s acquisition of the subject property; what might have satisfied the AAI at an earlier point might not be adequate at a later time in light of intervening advances in the environmental consulting industry.

The lack of a consistent statutory definition and specified standards for performing SARA’s AAI have led to various attempts over the years by certain special interest groups to establish a standardized methodology. The Federal National Mortgage Association (Fannie Mae) published in 1988 its guidelines for lending institutions originating loans to be purchased by Fannie Mae. The guidelines, labeled “Multi-Family Environmental Hazards Management Procedures”, generally called for historical records review, government records review, and a site inspection. The guidelines were revised in 1991 and again in 1994. The Federal Home Loan Bank Board (FHLBB) issued Thrift Bulletin 16 (TB-16) in 1989 detailing the environmental guidelines that federally chartered S & L’s were to follow in evaluating a mortgage loan on real estate. Site Auditing: Environmental Assessment of Property, Chapter 3, pp. 3-5, Specialty Technical Publishers (1992).

The Resolution Trust Corporation, formed in 1989 to implement the federal bail-out of the failing S & L industry, developed guidelines and procedures to evaluate the thousands of real estate assets it took over from failed thrift institutions. RTC’s 1990 Environmental Guidelines and Procedures Manual utilized a two (2) step screening process. The first phase consisted of an 11-point internal review to identify potential environmental issues. If the first phase results

including field inspection indicated concerns, the second phase called for outside consultation with an environmental consultant. Site Auditing, Resolution Trust Corp., Chapter 11, pp. 11-1 to 11-8.

The Federal Home Loan Mortgage Corp. (Freddie Mac) issued environmental requirements for multi-family residential properties in 1997. The requirements specify minimum qualifications for an approved environmental consultant and list eight (8) particular environmental hazards that must be evaluated. Special procedures and treatment of asbestos and lead-based paint are also addressed. Environmental Due Diligence Guide, "Identifying Contaminated Property", Section 111, p. 111:204, BNA (2001).

Various interested professional groups also attempted to craft a workable AAI for their constituencies. For example, the Association of Soil and Foundation Engineers (ASFE) published standards captioned "Preacquisition Site Assessment; Recommended Management Procedures for Consulting Engineering Firms" in 1989. The National Ground Water Association (NGWA) published its guidance manual "Guidance for Standardization of Environmental Site Assessments" in 1992. American Society for Testing Materials (ASTM) issued its Transaction Screen Process standard E1528-93 and its more detailed Phase I Environmental Site Assessment Standard E1527-93 in 1993. Site Auditing, Chapter 3, pp. 3-6 to 3-9.

The ASTM due diligence standards were the result of intensive collaboration among the 800 members of ASTM Committee E50 on Environmental Assessment. Perhaps in part because of the broad diversity of the ASTM Committee E50 membership, drawing from the commercial lending industry, environmental professionals, lawyers, professors and government agencies, the ASTM due diligence standards appeared to have gained the most acceptance as the standards likely to satisfy SARA's ILO defense requirement of consistency with "good commercial or customary practices." See BNA's Environmental Due Diligence Guide, §111.22, p. 111:202 (2001).

ASTM has revised and updated its screening checklist standard E1528, most recently in 2000. The Phase I Environmental Site Assessment Process, Standard E1527, has undergone revisions in 1994, 1997 and 2000, and again in 2005. More detailed discussion of the 2005 revisions to E1527 appears below.

C. Brownfields Act Revisions to Section 101(35) Innocent Landowner Defense.

The Small Business Liability Relief and Brownfields Revitalization Act of 2002, Pub.L.No. 107-118 ("Brownfields Act"), amended and revised the SARA ILO defense in several major ways.

The first significant change is that the legislation finally adopted specific standards for conducting the AAI component of the necessary "no reason to know" criteria for the ILO defense. Congress delegated to EPA the rule-making authority to establish by regulation the

particular standards and practices that would constitute the AAI. 42 U.S.C. 9601(35)(B)(ii). Congress listed ten (10) criteria that EPA must include in its final rule.

The second significant change is that the Act provided specific interim standards and practices for conducting the AAI, pending EPA's final rule. For properties purchased after 5-31-97 and until EPA's final rule, Congress stated that the ASTM standard E1527-97 will satisfy the AAI. 42 U.S.C. 9601(35)(B)(iv)(II). Note the referenced ASTM standard is not the exclusive method that can satisfy the AAI; the amendment continues to refer to "generally accepted good commercial and customary standards and practices." For properties purchased prior to 5-31-97, Congress declared that the same five (5) mandatory factors from the 1986 ILO defense would continue to apply. 42 U.S.C. 9601(35)(B)(iv)(I). These interim standards became effective on January 11, 2002.

The third significant change is that Congress spelled out a different AAI standard for residential property purchased by a non-commercial entity. The AAI safe harbor in those circumstances is a facility inspection and a title search confirming no basis for further inquiry. 42 U.S.C. 9601(35)(B)(v).

The fourth significant change is that Congress added new conditions subsequent upon the qualifying "innocent landowner." The innocent landowner must (1) provide full cooperation and site access to the cleanup authorities, (2) comply with any land-use restrictions imposed by the cleanup authorities, and (3) not impede institutional controls established for the facility. 42 U.S.C. 9601(35)(A). In addition, the "innocent landowner" must also take reasonable steps to (1) stop any continuing release, (2) prevent any possible future release, and (3) prevent or limit any exposure to previously released contamination. 42 U.S.C. 9601(35)(B)(i)(II).

The Brownfields Act amendments to the ILO defense pose a mixed bag. The incorporation of specific industry-recognized standards for conducting the AAI provides much-needed detail to the pre-purchase diligence task. But the continuing obligations now imposed upon the "innocent landowner" inject new uncertainties. Recalling that the 9607(b)(3) obligations to exercise "due care" and "take precautions" against foreseeable acts, omissions and resulting consequences continue to apply, the 2002 requirements that the innocent landowner also take "reasonable steps" in the three (3) respects stated raise unanswered questions.

D. Bona Fide Prospective Purchaser (BFPP) Defense.

The 2002 Brownfields Act created a new class of party exempted from liability for existing CERCLA-regulated contamination, the Bona Fide Prospective Purchaser (BFPP). This exemption is stated to run in favor of a party "whose potential liability for a release or threatened release is based solely on the party being considered to be an owner or operator of a facility." 42 U.S.C. 9607(r)(1). In contrast to the "innocent landowner" requirement of 'no reason to know' of any contamination, the BFPP may have actual knowledge of contamination at the time of its acquisition and nevertheless qualify for this exemption from potential CERCLA liability. 42 U.S.C. 9607(q)(1)(C). However, there are a number of conditions or criteria the

BFPP must satisfy in order to achieve the protection from CERCLA liability.

The statutory elements or criteria for BFPP status can be summarized as follows:

(1) all disposal of hazardous substances at the subject property occurred before the BFPP's acquisition; (2) the BFPP made AAI at the time of its acquisition; (3) the BFPP gave all legally required notices concerning the existence or release of hazardous substances at the property; (4) the BFPP used appropriate care by taking reasonable steps to (i) stop continuing releases, (ii) prevent future releases and (iii) prevent or limit exposure to contamination; (5) provides full cooperation, assistance and access to authorized persons performing cleanup activities; (6) complies with any land use restrictions pertaining to cleanup activities; (7) does not impede institutional controls utilized in cleanup activities; (8) complies with EPA information requests; (9) has no affiliation with a PRP, and is not a PRP at another facility; (10) does not impede cleanup activities, and (11) the acquisition occurred after January 11, 2002. 42 U.S.C. 9601(40) (A) - (H); 9607(r)(1). Another Brownfields Act consequence to note of obtaining BFPP status is the prospect that the BFPP's property could become subject to the so-called "windfall lien". The Act provides that a lien will attach to the extent EPA's unrecovered cleanup costs at the facility are unpaid and the cleanup increases the fair market value of the property. 42 U.S.C. 9607(r)(2),(3).

The AAI necessary to assert a claim to the BFPP status is the same level of due diligence as now required to qualify for the ILO defense, as revised. 42 U.S.C. 9601(40)(B)(ii).

E. Contiguous Property Owner (CPO) Defense.

The Brownfields Act establishes a statutory defense to CERCLA liability for certain property owners whose property is or becomes contaminated by a release of contamination from contiguous or nearby property. 42 U.S.C. 9607(q). The essential elements of this Contiguous Property Owner (CPO) defense include that the CPO prove that it did not cause or contribute to the off-site release and that at the time the CPO acquired its property, the CPO satisfied the "innocent landowner's" criteria of AAI (i.e., conducted all appropriate inquiry and did not know or have reason to know that its property was or could be contaminated by a release from off-site source). 42 U.S.C. 9607(q)(1)(A)(I); 9607(q)(1)(A)(viii). In addition, the CPO defense requires satisfaction of a number of other post-acquisition criteria or obligations common to the BFPP defense. See 42 U.S.C. 9607(q)(1)(A)(i) - (viii) (no affiliation with a PRP; take reasonable steps to stop a continuing release, prevent future release and minimize exposure to a release; provide full cooperation, assistance and access; comply with land use restrictions and not impede institutional controls; comply with EPA information requirements; and provide legally required notices).

II. EPA ADMINISTRATIVE GUIDANCE AND RULES

1. Interim Guidance March 6, 2003.

EPA's "Common Elements" Interim Guidance document dated March 6, 2003 provided general advice on a number of criteria relevant to the BFPP, CPO and revised ILO defenses. Of particular note below is the document's treatment of the AAI.

In the context of the document's insightful discussion of the "reasonable steps" requirement (common to the BFPP, CPO and ILO defenses), EPA provides several scenarios where it believes the results of the AAI should trigger affirmative action. Failure to act likely will disqualify the party from its desired BFPP/CPO/ILO status.

The first example posits a situation where the AAI detects hazardous substance contamination previously unknown. EPA states the putative BFPP/CPO/ILO then has the duty to notify appropriate governmental authorities even if the circumstance does not technically trigger a specific legal notice or reporting provision. EPA reasons that it would view such disclosure as a necessary "reasonable step" to either prevent a further release or limit exposure (Attachment B, Q & A #1). EPA further observes in a later example that once contamination is discovered on the putative BFPP/CPO/ILO property, that party should take certain basic steps to assess the contamination. EPA's rationale is that in the absence of conducting such further investigation and assessment, it would be very difficult to then determine what "reasonable steps" will be required to stop a continuing release, prevent further release or limit exposure (Attachment B, Q & A #8).

The above examples illustrates a dilemma the seller of property faces when its buyer desires to perform a pre-closing AAI. To the extent the seller fashions itself as qualifying as an ILO, previously unaware of any hazardous substance contamination on-site, the buyer's desired AAI activities may uncover adverse environmental information, forcing the seller to either act upon the new data or else risk forfeiting its perceived defense to CERCLA liability.

The standards or procedures approved by EPA for carrying out the AAI project are mentioned in the EPA document. Generally, the guidance document mirrors the Brownfields Act requirements: pre 5-31-97 acquisitions, one should follow the original ILO statutory criteria; post 5-31-97 acquisitions, one should follow the ASTM procedures (including E1527-97) until EPA issues its final rule.

2. Final Rule for Interim AAI Standards May 9, 2003

EPA issued a final rule clarifying the AAI standards to be followed for acquisitions occurring after 5-31-97 and until 11-1-06 (the effective date of EPA's final Rule on AAI).

EPA directed that for the transactions framed above, either the ASTM E1527-97 standard (specifically mentioned in the Brownfields Act) or the later revised ASTM E1527-00 standard would be acceptable. EPA's interim standards rule was prompted by the realization that the earlier E1527-97 standard was generally no longer available, since ASTM had replaced it with

the updated E1527-00 standard.

This final rule governing interim AAI standards became effective 6-9-03. 68 FR 24888.

3. Final AAI Rule November 1, 2005

EPA issued its Final Rule for AAI, captioned "Standards and Practices for All Appropriate Inquiries," on November 1, 2005. 70 FR 66070, codified at 40 CFR 312.1 to 312.31. The Final Rule was published pursuant to the express rule-making authority Congress granted EPA in the Brownfields Act. 42 U.S.C. 9601(35)(B)(ii). The Final Rule becomes effective November 1, 2006.

EPA's Final Rule recognizes the new ASTM E1527-05 standard as being substantively compliant with both the Final Rule as well as the Brownfields Act ten (10) statutory criteria for AAI listed at CERCLA § 101(35)(B)(iii). 70 FR 66081.

The objective of the AAI is to produce a documented, reasoned professional written report and opinion that identifies any conditions indicative of releases and threatened releases of hazardous substances on, at, in or to the subject property. 40 CFR 312.20(e); 40 CFR 312.21(c).

Using the standards, practices and procedures set forth in the Final Rule, the AAI must identify the following conditions and activities:

- (1) current and past property uses and occupancies,
- (2) current and past uses of hazardous substances,
- (3) waste management and disposal activities that could have caused a release of hazardous substances,
- (4) current and past remediation actions,
- (5) engineering controls,
- (6) institutional controls, and
- (7) adjacent and nearby property conditions that could have resulted in releases or threatened releases of hazardous substances to the property.

40 CFR 312.20(e)(1)

Refer to EPA's "Comparison of the Final All Appropriate Inquiries Standard and the ASTM E1527-00 Environmental Site Assessment Standard", EPA 560-F-05-242 (Oct. 2005) for a list of the major topics addressed in the Final Rule and helpful corresponding brief explanation (attached at the end of this outline).

A. Effect upon AAI Interim Standards

EPA's Final Rule replaces the 5-9-03 EPA interim standards rule. For properties

acquired after 5-31-97 and before 11-1-06, the permissible AAI can be satisfied alternatively under the approved interim standards (ASTM E1527-97 or ASTM E1527-00), or the new ASTM 1527-05 standard. For properties acquired after 11-1-06, the AAI must be done in accordance with either the ASTM 1527-05 standard or the procedures spelled out in the Final Rule. 70 FR 66072; 40 CFR 312.11.

B. Minimum Qualifications of the Environmental Professional

The bulk of public comments to EPA's proposed Final Rule were directed to the issue of the minimum professional and practical qualifications for conducting the AAI. The Final Rule establishes that the inquiry must be conducted by or under the supervision of an "Environmental Professional" (EP). 40 CFR 312.21. The EP must have either (1) a P.E. or P.G. license plus three years full-time relevant experience, or (2) a state or federal license to conduct an AAI plus three years full-time relevant experience; or (3) a B.S. degree in engineering or science plus five years full-time relevant experience; or (4) 10 years full-time relevant experience. 40 CFR 312.10(b)(2)(i)-(iv).

Some of the AAI tasks may be performed by an individual not qualified as an EP, but must nevertheless be done "under the supervision" of the EP. 40 CFR 312.10(b)(5).

The Final Rule requires the EP signing the written report to expressly represent that he/she meets the EP minimum qualifications, and has the requisite education, training and experience to perform an appropriate AAI of the specific property in question. The EP is required to disclose his/her qualifications to render the report. 40 CFR 312.22(d), (c) (3).

C. Role of the Environmental Professional

The EPA Final Rule seems to place greater emphasis on the judgment of the EP performing the AAI investigation. It is more than a "checklist" approach. See R. Cox, "Environmental Issues in Real Estate Practice," Mass. CLE Inc., p.6 (2006). For example, the Final Rule requires the EP to review and evaluate the thoroughness and reliability of information gathered during the AAI. 40 CFR 312.20(f)(2). The EP must reconcile, explain and draw a professional conclusion where the results of the investigation lead to "data gaps." 40 CFR 312.21(c)(2); 312.20(g). The EP has discretion to determine how far back to search historical records (40CFR 312.24(b)) and whether to modify the Rule's mandated search distances (40 CFR 312.26(d)). The EP is required to give an opinion whether additional investigation would be appropriate in light of the information and data gaps developed during the performance of the AAI. 40 CFR 312.31(b).

The EP's discretion and judgment also come into play when determining the extent of efforts to obtain desired relevant information. The Final Rule suggests employing a cost/benefit balancing test, without apparent further guidance, by its mandate to gather information that is (1) publicly available, (2) upon reasonable time and cost constraints, and (3) that can practically be

reviewed. 40 CFR 312.20(f)(1).

The Final Rule does allocate some of the AAI required activities specifically to the EP's client (the prospective BFPP/ILO/CPO). The client must evaluate its own specialized knowledge of the subject property and nearby conditions, and its relevant experience. 40 CFR 312.22(a)(2). The client must also evaluate the relationship of the purchase price to the hypothetical value if not contaminated. 40 CFR 312.22(a)(3). If the AAI relies upon a prior environmental report prepared for someone else, the client must review that report as it considers its specialized knowledge and experience. 40 CFR 312.20(d)(1), (2).

CONCLUSION

The pursuit of proper environmental due diligence to achieve innocent purchaser status in connection with real estate transactions has traditionally been an elusive moving target. While at first blush the passage of the Brownfields Act "All Appropriate Inquiry" and EPA's implementing 2005 Final Rule would appear to have cured the long-time absence of specific criteria, these advancements will likely bring into play their own host of problems, uncertainties and risks. The environmental consulting industry now has to figure out how to apply itself to a set of new procedures and protocols. Commencing November 1, 2006, the real estate investment industry must take an active role in the conduct of part of the actual due diligence. It can no longer simply read and react to the consultant's environmental report. The new additional post-acquisition obligations tacked on by the Act to the new owner injects added risk and heightens the consequences for performing inadequate transactional due diligence. It remains to be seen how the courts will interpret these due diligence issues.

Perhaps the only certain consequence of the AAI developments is that the complexity and cost of performing environmental due diligence will substantially increase for those who are serious about minimizing the liability exposure.