PROTECTING YOUR CLIENT'S BACKSIDE FROM ENVIRONMENTAL DOWNSIDE: HOW BUYERS CAN ASSESS AND MANAGE ENVIRONMENTAL EXPOSURE IN REAL ESTATE TRANSACTIONS

Author:
JOHN SLAVICH, *Dallas*
Guida, Slavich & Flores, P.C.

Co-author:
SALLY A. LONGROY, *Dallas*
Guida, Slavich & Flores, P.C.

State Bar of Texas
40TH ANNUAL
ADVANCED REAL ESTATE LAW
July 12-14, 2018
San Antonio

CHAPTER 6

JOHN SLAVICH
E-mail: slavich@gsfpc.com

John Slavich is a shareholder in the law firm of Guida, Slavich & Flores, P.C. He has a diversified environmental law practice where he provides strategic advice to clients on a broad range of environmental issues, including the environmental aspects of transactions, brownfields redevelopment, remediation matters, risk management, and compliance matters. His clients have included property purchasers and sellers, developers, investors, lenders, private and public property owners, and tenants. Mr. Slavich's environmental practice is complemented by more than a decade of prior experience practicing corporate finance and transactional law.

Mr. Slavich is a member of the State Bar of Texas and received his law degree from Washington University in St. Louis, where he was a member of the Board of Editors of the *Washington University Law Quarterly*. He earned his master of business administration degree from Southern Methodist University, and his undergraduate degree from Earlham College.

Texas Monthly magazine named him as a Texas Super Lawyer in their inaugural listing in 2003 and in each subsequent listing. He is also listed in *The Best Lawyers in America, Chambers USA – Guide to America's Leading Business Lawyers, and International Who's Who of Lawyers.*

Guida, Slavich & Flores, P.C.

5956 Sherry Lane	**106 E. 6th Street, Suite 900**
Suite 1000	**Suite 900**
Dallas, Texas 75225	**Austin, Texas 78701**
Ph: 214.692.0009	**Ph: 512.476.6300**

Website: www.gsfpc.com

SALLY A. LONGROY
E-mail: longroy@gsfpc.com

Ms. Longroy is a shareholder in the law firm of Guida, Slavich & Flores, P.C. She offers legal advice to clients on a wide variety of environmental matters, most often related to commercial real estate, corporate, or capital transactions. She enjoys finding ways to strategically manage environmental risks, address remediation matters, and ensure compliance with environmental laws, all while achieving her clients' goals. In addition to addressing the environmental aspects of transactions, Ms. Longroy helps her clients to structure, negotiate, and close complex commercial real estate transactions, including the purchase, sale, subdivision, and development of property, and the leasing of property for a variety of uses, including office, call center, data center, industrial, restaurant, and agricultural uses.

Prior to commencing her law practice, Ms. Longroy was first an analytical chemist then gained extensive regulatory experience with laws governing the registration and manufacturing of pesticides and animal drugs.

Ms. Longroy has been named as one of the Best Lawyers in Dallas by D Magazine each year since 2015, and has been listed in The Best Lawyers in America in the specialty of Environmental Law since 2007. Ms. Longroy was President of Commercial Real Estate Women (CREW) – Dallas in 2015 and served on its Board of Directors 2012-2017. She was Co-Director of the American Bar Association Section of Litigation Division overseeing Publications, CLE & Programs, 2009-2010, and served in various other Section leadership positions from 2000 to 2009, including Co-Chair of the Environmental Litigation Committee from 2000 to 2003.

Ms. Longroy received her J.D., cum laude, and Executive M.B.A. from Southern Methodist University. She has a B.S., in Chemistry, with distinction, from the University of Michigan.

Guida, Slavich & Flores, P.C.

5956 Sherry Lane
Suite 1000
Dallas, Texas 75225
Ph: 214.692.0009

106 E. 6th Street, Suite 900
Suite 900
Austin, Texas 78701
Ph: 512.476.6300

Website: www.gsfpc.com

TABLE OF CONTENTS

PROTECTING YOUR CLIENT'S BACKSIDE FROM ENVIRONMENTAL DOWNSIDE: HOW BUYERS CAN ASSESS AND MANAGE ENVIRONMENTAL EXPOSURE IN REAL ESTATE TRANSACTIONS

John Slavich and Sally A. Longroy

Environmental conditions at property can present liability exposure to the owners and tenants of that property. In some instances those conditions result in actual liability. In other instances there will be a perception of risk presented by environmental conditions. Whether the liabilities and risks are real or only perceived, the resulting concerns can adversely impact the marketability, lendability and developability of the property and thereby complicate negotiation of a transaction.

This paper is intended to provide an issue-spotting approach to assessing and managing environmental exposure in a real estate transaction, focusing on issues of particular concern to buyers. We have selected the relevant topics based on our experience in practicing in this area. Of necessity the discussion is cursory in many instances and does not attempt to reflect the detailed nuances involved, an approach which would have required a much longer treatise.

This paper begins with a brief overview of potential environmental liability exposures for a buyer and the process for assessing those exposures. Next, the paper will consider ways of managing environmental liabilities and risks, including through the contractual allocation of risk. Finally the paper will consider the challenges of walking away from legacy environmental liabilities when the buyer becomes a seller. Attachment I to the paper provides a checklist that a real estate practitioner can use to gather the initial factual information relating to environmental issues that can impact a transaction.

I. BUYER BE AWARE

A. Potential Environmental Liability Exposure.

By purchasing property, the new owner can be taking on various exposures related to environmental conditions. Some of those exposures will be generic and apply to all properties; others are site-specific.

1. Status Liability.

The most significant concern usually relates to remediation or "clean up" liabilities imposed without regard to fault. These liabilities arise out of the statutory schemes under federal and state environmental laws that impose liability based on a parties "status" with respect to a site (in contrast to liability based upon acts or omissions). Status liability is strict and, depending on the fact situation, can be joint and several.

Categories of "responsible parties" can include current owners and operators of property, former owners and operators of property (including previously divested property), and parties that generate or arrange for disposal of waste materials. Remedial liabilities can have the potential of exceeding the value of the assets acquired.

2. Liability for Historical Contamination.

A recurring issue is the potential liability of a party if it were to purchase property in Texas at which contamination is already present. While such "historical contamination" has not been defined for purposes of Texas law, the term is generally considered to refer to contamination that already exists at a site when a new party purchases that site, and did not result from an act or omission of that purchaser or an affiliated party.

There are two primary provisions that drive the analysis of potential liability exposure: Section 26.121 of the Texas Water Code and 30 Tex. Admin. Code § 335.4. Each of the cited provisions is written broadly with language ("suffer, allow or permit") that appears, on its face, to require a property owner to address contamination present at a site it owns (including historical contamination), notwithstanding there being no act or omission of the property owner that resulted in the contamination being present. Violation of those provisions has the potential of leading to regulatory enforcement actions and the imposition of civil penalties and closure/remedial obligations by the State.

3. Reporting.

There has been an ongoing controversy as to whether a property owner is required to report historical contamination to the Texas Commission on Environmental Quality ("TCEQ"). The State takes the position that § 26.039 of the Texas Water Code provides the standard for determining reporting obligations, including those for historical contamination. Because that statutory provision appears to apply to an identifiable spill episode that causes or may cause pollution impacting "water in the state" (which includes groundwater), many environmental practitioners question the State's statutory interpretation. No court has delivered a definitive interpretation, but an excellent discussion of both positions can be found in Baker and Morton, "Historic Contamination: The Situation Here is Not What it Seems!," Texas Environmental Superconference (August 1999).

4. Third-Party Liability.

Third parties, including owners and operators of adjacent property, may be impacted by contamination at or migrating from a property. Even though a property owner may have not caused those impacts, there can be a concern that impacted third parties may nevertheless assert various common law causes of action and attempt to make claims for, among other things, remediation, property damages or personal injury, or proceed under the statutory cost recovery provisions of § 361.344 of the Texas Solid Waste Disposal Act or, if appropriate, the federal Superfund statute (42 U.S.C. § 9601 et seq.).

Government entities can also bring claims against a property owner for natural resource damages, impose fines and penalties, and request injunctive relief relating to site conditions.

5. Activity and Use Limitations.

Property may also be burdened with activity and use limitation (AULs) imposed in connection with regulatory closure activities that have previously been conducted at the property or other contractual obligations that burden the owner of the property. AULs can take various forms such as:

- A requirement that specific future activities be conducted at a site. [Example: an obligation to inspect and maintain a cap, such as a building foundation or paved parking lot, which serves as a physical control.]
- A prohibition of activities. [Example: a restriction on use of groundwater.]
- A restriction on land uses. [Example: a prohibition of residential use at a property.]
- Notice of site conditions. [Example: a notification of the presence of contamination that could result in vapor intrusion into structures.]

Identifying existing AULs and understanding the potential impact of those AULs on property being acquired is important for a number of reasons.

a. Finding the AULs.

ASTM E1527-13, the standard used to perform Phase I environmental site assessments, does not require the consultant to review recorded land title records or judicial records for AULs. Consequently, unless the consultant's engagement specifically includes such a review in the scope of work to be performed, the environmental site assessment report will not be required to identify AULs. In that case, the buyer will need to independently make those inquiries and then inform the consultant of AULs identified.

Although an AUL may have been required to be filed in the real property records, the filing might not have happened. A buyer should ask its environmental consultant to identify AULs referenced in its review of governmental environmental files as part of the due diligence process so that the consultant or others can then check to see whether those AULs have been filed of record. Additionally, it has been our experience that a title company may not always identify those obligations in connection with providing title work.

b. Impact of the AULs.

Where AULs are identified by parties other than the environmental consultant (such as the title company), the buyer would be well served to have the environmental consultant explain the impact of those AULs in the context of the site conditions identified in its environmental reports. The presence of a required cap or other physical control at a property can impair the new owner's intended use of the property. Existing remediation equipment operating at the property may limit use of certain portions of the site. Physical controls can impose operational, inspection, and maintenance obligations. Those obligations can include reporting to the State regarding the effectiveness of the physical controls and financial assurance requirements. State approval for disturbance or modification of the control can potentially have a material impact on site redevelopment, as well as marketability. It can also impact everyday operations, such as where a sewer or plumbing leak that necessitates immediate action would require coordination with the State.

c. Lender Concerns About AULs.

Deed notices can also trigger lender concerns, as we have seen with required notices regarding the possibility of vapor intrusion. Lenders may insist on the addition of vapor barriers or vapor mitigation systems to address a potential issue before funding a construction project.

d. Additional Response Actions Required by AULs.

Where TCEQ has issued a conditional Voluntary Cleanup Program Certificate of Completion ("COC") or a No Further Action ("NFA") letter under its Corrective Action program acknowledging partial completion of response action at a property, additional response action will be required to complete the regulatory closure process. As a result, certain obligations or restrictions will be imposed on the property until the additional response action has been completed.

e. Responsibility for Compliance with AULs.

Where AULs attach to a property, there will be questions of whether those obligations have been properly addressed and the conditions met, after their imposition and prior to the buyer's acquisition of the property. If obligations remain (including additional response actions), the buyer will want to find out if a

party (other than the buyer) is obligated, by contract or otherwise, to complete the response actions. If so, the buyer will also want to know that party's obligations and whether that party has the financial wherewithal to perform. The potential consequences of failure include voiding previous regulatory closure determinations by TCEQ.

f. Buyer as a Responsible Person.

The Texas statute that defines a person "responsible for solid waste" uses a strict (without fault) standard that can also impose joint and several liability on responsible persons. Liability under the statute extends to current and, in certain circumstances, former owners or operators of a site. At a site that has received regulatory closure from the State, a change in the land use from that specified in the AUL (such as redeveloping for residential use property previously restricted to commercial/industrial use) or the failure to maintain a required control is considered a substantial change in circumstances under TCEQ regulations. In those instances, the State may impose liability on the person that caused or allowed such act or omission and, in certain circumstances, also pursue others who would qualify as a responsible person for the site.

g. Compliance with AULs and Superfund Liability Exemptions.

Compliance with AULs is a specified condition the buyer will need to meet to qualify for the exemptions from liability under the federal Superfund statute available to eligible bona fide prospective purchasers, innocent landowners, and contiguous property owners. There are no comparable statutory exemptions under Texas law.

6. Operating Requirements.

If the real estate being purchased includes operating assets, there may be requirements that can impact a buyer's ability to operate the assets it purchases. Continued operations may require permits or other approvals of governmental authorities or third parties that need to be transferred or otherwise obtained. Regulatory requirements may also restrict expansion of current operations.

B. Assessing Environmental Exposure.

A pre-purchase due diligence assessment process is used by a buyer to help it assess potential environmental exposure. This investigation process will help the buyer identify liabilities and risks relating to the property and assess compliance with requirements relating to any operating assets. The process can also serve to develop information that a buyer can use for negotiating the contractual risk allocation provisions and the purchase price for the property. It can also provide a baseline analysis of existing property conditions where the contractual agreement provides for post-closing obligations of the seller or buyer.

1. The Assessment Process.

The environmental assessment process used for pre-acquisition due diligence involves a series of steps to identify environmental liabilities (that is, known or expected obligations or expenses based on known conditions) and to attempt to determine environmental risks (that is, potential exposures based on known or unknown conditions) arising out of current and historical site conditions and operations. Data gaps, where historical information is not available, can present a challenge.

The environmental assessment is usually performed by a technical consultant coordinating with the buyer's counsel. Scoping the assessment is a deal-critical task. The scoping process for pre-acquisition due diligence will take into consideration the following:

- The stated purpose for the assessment.
- What documentation is to be reviewed and what, in the event of a multi-property deal, sites are to be visited.
- The issues to be covered in the consultant's report.
- Interface between consultant and representatives of the seller and buyer.
- The staffing and timetable for the component parts of the assessment.
- Whether subsurface or other sampling will be performed.
- Concerns involving confidentiality issues and the seller's sensitivities to discussion with governmental authorities.
- Availability of existing information in the seller's files and the buyer's access to and ability to rely on those materials.

The goal of the assessment process is to provide information from which the buyer can assess potential liabilities and risks, establish guesstimated ranges for the cost of any remediation it deems necessary or appropriate, and negotiate the deal. The process involves legal, technical, financial, and business risk judgments and involves balancing the up-front time and investigative costs against the potential later expense arising out of undiscovered conditions.

2. Types of Assessments.

Two types of environmental assessments are commonly used by buyers to investigate property. A Phase I environmental site assessments uses a review of historical uses and aerial photos, regulatory records review, interviews, and site visits to evaluate the

potential for "recognized environmental conditions" (RECs). The ASTM E1527-13 protocol serves as the industry-standard best practice for Phase I assessments and is designed to meet the "all appropriate inquiry" component required to qualify for various defenses to liability available under the federal Superfund law. A Phase I site assessment is considered a qualitative, rather than a quantitative exercise, and as a result has various shortcomings. Of particular importance, there is no subsurface investigation component. There are many times gaps in information availability, and the assessment scope established by ASTM E1527-13 does not require analysis of certain potentially important concerns to a buyer, especially if the buyer plans future redevelopment of the property. Issues not covered by the environmental site assessment conducted using ASTM E1527-13 include:

- Wetlands
- Endangered species
- Asbestos
- Lead paint
- Mold
- Regulatory compliance

Phase II site investigations involve physical testing, including subsurface sampling of soil and groundwater, to determine if property has been environmentally impacted. Data generated are then compared against various applicable governmental standards to determine if there are contaminants present that exceed permissible levels. A Phase II site investigation provides quantitative information, but its ability to adequately quantify environmental costs is highly dependent on its scope. The typical goal of a Phase II investigation is to address the RECs identified in the Phase I and determine whether environmental conditions in fact exist at the property and if so, the implications of the presence of those conditions.

Operations assessments are used if operating assets are part of the transaction. Those assessments determine compliance of existing operations with applicable environmental, health, and safety laws and regulations, including permitting requirements.

Property condition assessments are performed to identify the physical condition of buildings and building systems (such as heating and air conditioning, electrical, and plumbing) along with other improvements. These types of assessments are separate from the environmentally-related assessments, but may also involve health and safety components as well as analysis of building code compliance.

The results of the assessments are set forth in reports prepared by the consultant that performed the work. As discussed in Section III.A.3 of this paper, best practice is to have the reports reviewed by a knowledgeable environmental attorney in draft form before the reports are final.

3. Governmental Comfort.

If pre-purchase due diligence identifies the presence of environmental contaminants, the buyer, along with its lenders, will typically want comfort that the site conditions do not pose a threat to human health or the environment. Phase II reports may provide sufficient comfort where sampling indicates no exceedances of permissible regulatory levels. Where, however, environmental contaminants have exceeded permissible regulatory levels at a property, the buyer parties will want to know whether the appropriate governmental authorities have been presented with data regarding the site conditions and then made a determination that a response action has appropriately addressed those contaminants or, alternatively, that a response action is not necessary.

In Texas, the governmental determination will typically take place under one of several TCEQ regulatory closure programs: the Voluntary Cleanup Program (VCP), the Petroleum Storage Tank (PST) program, or the Industrial and Hazardous Waste program (generally referred to as Corrective Action). The response action necessary for regulatory closure will be governed either by the Texas Risk Reduction Program (TRRP) rules in 30 Tex. Admin. Code § 350 or, in the case of petroleum storage tanks, by the PST rules in 30 Tex. Admin. Code § 334.

a. TCEQ Closure Determination.

If environmental contamination conditions needed to be addressed, and if appropriate remediation has been performed under a TCEQ program, TCEQ will confirm in writing that no additional response actions are necessary at the affected property. The written form of the State's determination will depend on which TCEQ program issues that confirmation. A Certificate of Completion ("COC") is issued under the VCP. A "no further action" ("NFA") letter is issued under the PST and Corrective Action programs. There are some critical differences between a COC and an NFA letter.

A COC is intended to address all contaminants within designated boundaries at a property entered into the VCP. A COC, once issued, then provides a release of liability from the State to future purchasers and also to any purchaser enrolled as a VCP applicant prior to acquiring the property. The COC relates only to the land use contemplated by the COC (residential or commercial/industrial) and only to contaminant releases that occurred prior to the date of the COC.

In contrast, an NFA letter will generally apply to particular contaminants identified in the specified area of the property at which a response action was

performed. An NFA letter, once issued, confirms the State's determination that the response actions performed met the then-applicable State remediation standards for the contaminants at the area of the site addressed. Unlike a COC, an NFA letter does not provide a release of liability from the State. Notwithstanding the State's issuance of an NFA letter for all or a portion of a site, the State could seek to pursue persons that qualify as a "responsible party" under the Texas Health and Safety Code for cleanup liability in certain instances, such as a substantial change in circumstances (as defined in 30 Tex. Admin. Code § 350.35) at the site. Examples include:

- A change in land use from that specified in the NFA letter.
- A failure to maintain a required physical or institutional control.
- A later determination that the technical information that supported the State's NFA decision did not sufficiently characterize threats to human health or the environment.
- A change in the State's cleanup standards.

Consequently, an NFA letter can be characterized as recognizing that there is no further action required at the time the letter is issued. In analyzing the effect of an NFA letter, not only the time-specific nature of the NFA letter should be considered, but also the scope of that letter, since the NFA determination may not extend to the property in its entirety or to all conditions at the property.

Neither COCs nor NFA letters provide protection from third party claims. The determination by TCEQ that environmental conditions at a site meet State standards may, however, under Texas case law serve to limit the ability of a third party to prove up damages from contamination.

b. Conditional Closure Determinations.

The State may alternatively issue COCs or NFA letters that acknowledge conditional or partial completion of response action at a property, but require additional response action. As a result, certain obligations or restrictions are then imposed on the property until the additional response action has been completed.

As noted earlier with respect to AULs, buyers will want to consider how such obligations or conditions may adversely impact the buyer's intended use of the property. A related question is whether those obligations have been properly addressed, and the conditions met, after their imposition and if not, the potential consequences of that failure. Finally, if additional response actions remain, is there a party (other than the buyer) contractually obligated to complete the response actions and, if so, what are that party's obligations?

c. Post Regulatory Closure Matters.

COCs and NFA letters provide comfort that governmental standards at a property were satisfied at the date the State issued its determination, but that may not be the end of the story. Events impacting the property (including offsite events) which occurred subsequently to TCEQ's regulatory closure determination could limit the comfort provided by an NFA letter or a COC. A release of contaminants at property subsequent to the issuance of a COC is not covered by the release of liability under that COC. Also, an NFA letter does not extend to the discovery of previously unknown contaminants at property. Additionally, if a COC or NFA letter imposes controls or if there are other AULs, the buyer will want to factor those into its transactional analysis.

II. RISK MANAGEMENT MECHANISMS

A. Remediation Agreements

A remediation agreement is one of the available risk management mechanisms that can be used to address environmental conditions of concern identified at a property. Under a remediation agreement, the transaction parties can identify how the environmental conditions of concern are to be addressed and which party will be obligated to address them.

Remediation can be performed prior to the purchase of the property, with completion of the remediation, usually accompanied by a COC or NFA letter to be a condition of the buyer's obligation to close on the property. Alternatively, the agreement can create specified obligations to be performed post-closing. In most instances the party performing those contractual obligations is the seller, although there is no reason the agreement cannot be structured to have buyer perform the remediation. Among the components typically included in a remediation agreement are the following:

- Access, if the party performing the remediation is no longer the owner of the property.
- The State program to be used to perform remediation of the conditions of environmental concern.
- The cleanup standard to be utilized that is acceptable to the buyer, since under the risk-based methodology used by TCEQ, certain contaminants can be left in place at property, but there may consequently be restrictive covenants or other AULs imposed on the property.
- A schedule for completion of work and remedies in the case of delay.

- A mechanism for remedies in the event of the obligor's default under the remediation agreement.
- Qualifications and insurance requirements for contractors performing remediation
- Indemnity against claims or damages arising out of the remedial work.

Where remediation is performed post-closing by the seller, a buyer is well advised to require a portion of the purchase price be held in escrow by a third party to be used to reimburse the seller for the cost of performing remediation work. Reimbursement may be structured so that disbursement is made based upon monies spent by the seller or, alternatively, on certain regulatory closure milestones being met.

B. Contractual Allocation of Environmental Liabilities and Risks.

Because of the "status liability" that comes along with ownership of property, buyers will be concerned about the risks of unknown environmental conditions at, or future circumstances affecting property, not just the liabilities that can arise out of known conditions. As a result, the buyer will want to try to avoid liability for pre-closing site conditions. An indemnity agreement is one of the mechanisms for doing so.

An indemnity agreement can address a buyer's concerns about how environmental liabilities and risks associated with site conditions may impact the buyer's ability to finance its purchase of the property, to lease or redevelop the property, and at some point in the future, to successfully exit its ownership position. A seller, on the other hand, may try to transfer to the buyer all obligations regarding environmental liabilities and risks with respect to a property so it will not have legacy liabilities remaining after the sale closes. In order to do that a seller will seek to utilize a trifecta of contractual provisions to allocate environmental liabilities and risks: "as is," release, and indemnity provisions.

A detailed discussion of these topics can be found in the following papers: Locke, "Chapter 4, Risk Management," 40th Annual State Bar of Texas Advanced Real Estate Law Course (July 2018); Slavich and Goldman, "Allocating Environmental Liabilities and Risks by Contract and Making that Stick," 33rd Annual State Bar of Texas Advanced Real Estate Law Course (July 2011).

Where a buyer relies upon contractual indemnity for protection, a particular concern will be the indemnitor's ability to perform under the indemnity. That will depend in large part upon the indemnitor's financial wherewithal at the time a claim arises. A buyer can mitigate that financial risk through the use of third party obligations.

Where a buyer has concerns about the seller's financial wherewithal, the buyer can see if it can negotiate a pledge of additional collateral to secure the seller's indemnity obligations. Also, the buyer may seek guarantees by the seller's principals or other affiliates that would allow the buyer to look to the assets of those parties in the event the seller does not have the financial wherewithal to perform its contractual obligations. Additionally, letters of credit and other third party financial guarantees of payment can be used to secure the seller's contractual obligations, with a third party agreeing to assume the risk, for a fee, of the seller not performing its contractual obligations.

C. Environmental Insurance.

Environmental insurance may also be available to provide protection to the buyer, as the alternative, in whole or part, to a seller's indemnification obligation. An insurance company would be expected to have the financial wherewithal to fulfill its policy obligations.

1. Pollution Liability Insurance.

Pollution liability policies can provide coverage for investigation and cleanup costs, bodily injury, property damage, natural resource damages assessments, and loss of business income. Coverage usually will not extend to cleanup of certain "known" conditions, thus not providing coverage for remediation of the issues that are the primary concern to the buyer. Coverage may not be available at all where the contamination has not been fully delineated or the government has not approved a remedial plan. Coverage for third party claims for bodily injury or property damage may be available even for "known" conditions. Where "known" conditions exist, it is sometimes easier to quantify the potential costs of cleanup than the potential costs of tort liability. In these situations, pollution liability insurance may be paired with remediation agreements, escrows, letters of credit, or purchase price holdbacks and possibly cost cap insurance (described below) to effectively manage "known" conditions risks.

While a buyer may consider insurance as an alternate to a seller indemnification obligation, it needs to keep in mind that an insurance policy is written with limits on both the duration and dollar amount of coverage provided, has certain significant exclusions, and may not be renewable at the end of its stated term. Also multi-year policies do not reinstate limits annually. Some environmental insurers will write policies on an "excess of indemnity" basis, where the policy is structured to respond to certain situations where the seller's indemnification obligation has been exhausted.

2. Cost Cap Insurance.

Cost cap policies provide coverage to protect against cost overruns in remedial projects. Policies are

underwritten based upon an expected budget for cleanup work, usually once a remediation plan has been approved by regulators. Policies are to pay out, up to the policy limits purchased, if the actual costs exceed the budgeted costs plus a negotiated buffer amount (expressed as a percentage of budgeted costs or specific dollar amount). When the policy begins paying in excess of the buffer amount, the insured will also have a co-payment obligation up to the limits purchased.

There is a very limited market of underwriters currently willing to write cost cap insurance, and policies are available only for larger remediation projects. The few insurers remaining in the market generally have minimum premiums at or above $200,000 and limits available tend to be less than $5 million.

3. Environmental Liability Buyouts.

Environmental liability buyouts may be utilized where a buyer is unwilling to assume full financial responsibility for cleanup of specified known environmental liabilities and related liabilities and risks. Buyouts utilize a third party company that agrees to complete the cleanup and assume certain defined liabilities and risks, generally in exchange for an upfront lump sum payment. The buyout company may utilize a variety of mechanisms to assure performance, including segregated escrow or trust funds, pollution liability and cost cap insurance, indemnities, corporate guarantees, cost-sharing agreements, and performance bonds. In a true environmental liability buyout, the obligations assumed by the buyout company are unlimited as to amount, duration, and scope of environmental remediation obligations and backed by the balance sheet of the buyout company's parent corporation.

4. Guaranteed Fixed-Price Remediation Contracts.

Guaranteed fixed-price remediation (GFPR) contracts operate similarly to environmental liability buyouts, where a party transfers its remediation obligations to an environmental remediation firm for a single, lump-sum payment. In a GFPR, the remediation obligations assumed by the environmental firm are often capped at a specific dollar amount and may be limited to the specific scope of work agreed between the parties. The environmental firm assuming the remediation obligations under a GFPR may use some or all of the same risk transfer mechanisms to assure performance as environmental liability buyout firms.

III. OTHER CONSIDERATIONS.

A. Buyer as Seller.

The real estate adage that "a buyer immediately becomes a seller" has particular applicability in dealing with environmental challenges at property. In large part the concerns arise out of the so-called "Hotel California" problem. In that 1977 recording by the Eagles, lyricists Don Henley and Glenn Frey observed (albeit in another context) that "you can check out any time you want, but you can never leave." Such is the challenge presented by status liability under federal and state environmental laws, given that responsible parties include former owners and operators. Additionally, as noted above, there are obligations that can arise in the regulatory closure process which if not satisfied after the sale of property can arise as liabilities of the previous owner. The risk management mechanisms mentioned in Section II of this paper can be utilized in an attempt to mitigate the legacy liabilities, but depending upon the factual circumstances, may not provide all the protection needed. Consequently, a prospective purchaser of property is well advised to consider various matters that can arise in connection with its eventual sale of the property. Several of these issues are noted below.

1. Conditions Can Change.

Even if a buyer received a "clean" Phase I when it purchased the property, it does not mean that a prospective purchaser will not raise potential environmental issues. Site conditions can change during the period of ownership of the property. A prospective purchaser will usually require a new assessment of the situation rather than trying to rely on reports the current owner had commissioned at an earlier time. New site conditions triggering concerns can arise from operations on the marketed property and conditions on neighboring properties. Buyers need to keep in mind that their risk tolerance, and their determinations of what and how much data may be gathered during their pre-purchase due diligence, will not necessarily be shared by prospective purchasers. The lack of baseline data from invasive sampling may cause concern to a prospective purchaser. For example, the presence of fill on the property can cause concern when there is no sampling data confirming the fill is clean.

2. Regulators' Concerns Can Change.

TCEQ may unilaterally change its approach to regulatory concerns without prior notice to the regulated community. Those changes can complicate deals. An example is TCEQ's approach regarding vapor intrusion from volatile organic compounds (VOCs) present in soil or groundwater. Although TCEQ has not issued regulatory guidance regarding sites where VOCs are present, recent experience is that TCEQ is *de facto* regulating those issues by requiring additional investigation, mitigation, or institutional controls before agreeing to grant regulatory closure. Matters considered as a significant change in circumstances may also result in TCEQ reopening a previous regulatory closure determination.

3. Consultant Reports Live On.

Section 4.6 of ASTM E1527-13, the protocol typically used for pre-purchase due diligence, limits continued viability of a Phase I report, but as a practical matter consultants' reports have a life of their own extending far into the future. That becomes an issue when a prospective purchaser's contract requires the seller to provide all environmental reports in its possession regarding the site, or where the seller provides all reports to avoid any later claim of failure to disclose if it were to withhold outdated reports. Buyers should anticipate that the reports they commission in connection with pre-purchase due diligence analysis will be reviewed by other third parties in the future. Consequently, buyers are well advised to have an environmental attorney review drafts of all reports prepared by environmental consultants to identify and discuss with the consultant language in the report that could be seen as problematic in the future.

4. Future Investigation.

Where new site conditions of concern have occurred after the purchase of a property, the property owner should expect a prospective purchaser to require subsurface investigation, but sampling after the property has already received regulatory closure can create issues. Additional sampling by a prospective purchaser may only muddy the waters where TCEQ previously determined the property met applicable regulatory standards even though residual contamination continues to be present. Also, subsurface sampling may lead to governmental reporting obligations as a result of data collected.

5. AUL Obligations.

When the buyer considers its exit from the property, the buyer should also take into account the implications if future purchasers or tenants do not address AUL obligations, potentially resulting in liability to the buyer as a former owner of the property. Having the new purchaser contractually obligated to assume AUL obligations may provide protection to a seller, but imposing those obligations on subsequent purchasers may be challenging.

B. Environmental Disclosures.

There are various environmentally related disclosures that need to be considered in connection with the sale of commercial property in Texas.

1. Knowledge of Releases.

In order to maintain applicable defenses to liability under the Texas equivalent of the federal Superfund law, a seller must disclose to a purchaser the seller's actual knowledge of a release or threatened release of a hazardous substance at a facility during the time the seller owned that property (Texas Health and Safety Code § 361.275(g)). Similar provisions can be found in the federal Superfund law (42 U.S.C. § 9601(35)(C)).

2. USTs/ASTs.

A party that sells property with an underground storage tank or an aboveground storage tank must provide the purchaser with written notification, prior to closing, of the tank owner's regulatory obligations. Those obligations include tank registration, compliance self-certification, and construction/installation notification provisions. (30 Tex. Admin. Code § 334.9). The regulations provide examples of language deemed sufficient to meet the disclosure requirements.

3. Notice of Response Action or Use Limitations.

For properties enrolled in the Corrective Action or VCP programs, the TCEQ would be expected to require an institutional control (e.g., deed notice or restrictive covenant) to be filed in the county records if a property is affected by contamination that will not be removed or decontaminated to below the residential protective concentration levels. Until any required institutional control is filed or the TCEQ has approved a report indicating that a response action has been completed with no institutional controls required, a property owner must inform any prospective purchaser or tenant of "any existing or planned response actions and of any current or future potential limitations on the use of the property." (30 Tex. Admin. Code § 350.31(i)).

4. Asbestos.

Federal Occupational Health and Safety Administration ("OSHA") regulations regarding asbestos require that building and facility owners determine the presence, location, and quantity of asbestos containing materials ("ACM") or presumed asbestos containing materials ("PACM"), inform employers and employees about the presence and location of ACM and PACM, maintain records regarding that information, and transfer those records to successive owners. (29 C.F.R. § 1901.1001(j)(3)).

5. Mold.

The Texas Mold Assessment and Remediation Rules require a seller to provide a purchaser with a copy of each Certificate of Mold Damage Remediation issued for the property during preceding five years (25 Tex. Admin. Code § 295.327(d)).

C. State of Texas Environmental Programs.

Section I.B.3 of this paper described regulatory closure under the State's VCP, PST and Corrective Action programs. There are issues under those programs and under other state programs that a buyer

should consider in negotiating its transaction and in anticipation of its future sale of the property.

1. Application to a TCEQ regulatory closure program.

When cleanup at a site enrolled in the VCP is complete, TCEQ issues a COC. The COC includes a release in favor of certain parties of liability to the State of Texas. The form of COC issued by TCEC states the following:

> *The following persons are qualified to obtain the protection from liability described in Section 361.610 of the Texas Health and Safety Code:*
>
> *1) An applicant who on the date of submittal of an application to the Voluntary Cleanup Program was not a responsible party under Sections 361.271 or 361.275(g) of the Texas Health and Safety Code; and*
> *2) All persons (e.g., future owners, future lessees, future operators and lenders) who on the date of issuance of this Certificate were not responsible parties under Sections 361.271 or 361.275(g) of the Texas Health and Safety Code.*

If a buyer is to acquire property that will require remediation, but which has not yet been entered into the VCP, the buyer must become a VCP applicant before acquiring the property in order to benefit from the liability protection afforded by the provisions noted above. The reason is that a prospective property interest holder would not be a "responsible party" for purposes of the VCP, and TCEQ interprets item *1)* above to say that the buyer would be entitled to the liability protection because it was a prospective property interest holder at the time it became a VCP applicant. If a buyer is to acquire a property already enrolled in the VCP prior to completion of regulatory closure and the issuance of a VCP COC, it will need the VCP Application and Agreement to be amended to include it as an additional VCP Applicant so the buyer can be eligible for the release of liability from the State of Texas when the COC is issued. Additionally, if a buyer is to assume the responsibilities to perform remedial obligations under the existing VCP program for a site after its acquisition, it will need to submit amendments to the VCP Application and Agreement to become the primarily responsible applicant (Applicant A) in replacement of the party relinquishing those remedial obligations. For a more detailed description of the VCP, see Slavich, "Texas Voluntary Cleanup Program," in *Brownfields: A Comprehensive Guide to Redeveloping Contaminated Property* (American Bar Association, Third Edition 2010).

A release of liability is not available under Corrective Action or the PST program. Consequently, there is not an issue that will drive the timing of entering a property into either of those programs.

2. Municipal Setting Designations

Municipal Setting Designations (MSDs) were created by the Texas Legislature as a legislative amendment of the regulatory provisions established by TCEQ in their TRRP standard. (Tex. Health & Safety Code Ann. § 361.8065(a)(2) (Vernon Supp. 2016)). The MSD is neither a stand-alone regulatory fix for a contaminated property nor a substitute for a VCP COC certificate of completion or a No Further Action determination by TCEQ. Rather, it is a mechanism intended to be used as a component part of the State's regulatory closure process and to demonstrate that health risks are not presented because groundwater is not used for potable purposes.

An MSD is a specified geographic area where the use of groundwater for potable purposes is prohibited. The prohibition is in the form of a municipal ordinance or a restrictive covenant filed in the county deed records and enforceable by the municipality in which property is located, which specifies both the horizontal boundaries of the MSD and the vertical extent of the groundwater that is prohibited from use. The MSD process also requires TCEQ certification of the municipal ordinance or restrictive covenant, as evidenced by TCEQ's issuance of an MSD certificate.

Certification of an MSD affects TRRP standards by changing the applicable assessment and cleanup levels for soil and groundwater with respect to the MSD site. So long as groundwater contamination is not causing, and is not reasonably anticipated to cause, off-site impacts to human health within a one-half mile buffer zone surrounding the MSD, then soil and groundwater assessment and cleanup levels based directly or indirectly on safe drinking water standards do not apply under TRRP. Certification of an MSD does not, however, eliminate all assessment and cleanup requirements under TRRP. While two of the groundwater-related exposure pathways (ingestion and protection of groundwater from surface and subsurface soil contamination) are eliminated from the risk analysis under TRRP, there are other groundwater pathways that must still be considered and either eliminated or addressed.

Before TCEQ may certify an MSD, the applicant must provide, among other things, resolutions in support of the MSD adopted by (i) the city council of the municipality in which the MSD is located and any other municipalities lying within the boundaries of the MSD and one-half mile buffer zone and (ii) the governing

body of each municipal and retail public utility owning a groundwater supply well within five miles of the MSD. Those statutory requirements can introduce a political component into the MSD approval process.

By eliminating the need to remediate contaminated groundwater, and by adjusting soil standards which can reduce the amount of soil that will need to be removed or otherwise remediated to relieve regulatory closure, an MSD can dramatically decrease the time and cost to receive a regulatory closure determination from TCEQ for a property with known contamination.

For a more detailed discussion of MSDs, see Slavich, "Texas Municipal Setting Designations," in *Implementing Institutional Controls at Brownfields and Other Contaminated Sites* (American Bar Association Second Edition, 2012).

3. Innocent Owner/Operator Program.

The Innocent Owner/Operator Program (IOP) is codified at Tex. Health & Safety Code Ann. §§ 361.751 *et seq*. Under that statutory provision an "innocent" owner or operator will not be liable under the Texas Solid Waste Disposal Act or the Texas Water Code for "investigation, monitoring, remediation, or corrective or other response action regarding the conditions attributable to a release or migration of a contaminant or otherwise liable regarding those conditions." To qualify as an "innocent" owner or operator, a person must own or conduct operations on property that has been contaminated from an off-site source (i.e., a source that is not located on the property) and not have caused or contributed to the off-site source of the contamination. Despite the name of the statutory program, the "innocence" is that of the property, not of its owner or operator. A qualifying party may seek from TCEQ a certificate confirming that the person is an "innocent" owner or operator. An IOP Certificate is issued with respect to specific contaminants (and in certain cases related daughter products) that are demonstrated to have impacted the subject property, and specific affected media demonstrated to have been impacted, from an offsite source. (In contrast, a VCP Certificate of Completion relates to all contaminants in all media at a subject property.). While an IOP certificate provides immunity from liability to the State, it does not address remediation of the contamination at the impacted site and does not provide regulatory closure with respect to the contamination. Additionally, the certificate is issued to the applicant and is not transferable, so it does not does not run with the land. In order to obtain State confirmation of the buyer's status as an innocent owner/operator, the new owner will need to apply for a new IOP Certificate after it acquires ownership of property.

4. Dry Cleaner Remediation Program.

The Dry Cleaner Environmental Response Statute, codified at Tex. Health & Safety Code § 374.001 *et seq*., created a State fund to pay for State-lead cleanup of dry cleaner-related contaminated sites, and the Dry Cleaner Remediation Program ("DCRP"), which provides for State-lead cleanup of site contamination from a retail dry cleaning establishment (Tex. Health & Safety Code § 374.153). The Statute provides that if a contaminated dry cleaning site has been "ranked" by TCEQ after application to the DCRP, then the State of Texas may use money from the fund for corrective action at the site. Once TCEQ has completed the necessary corrective action under the DCRP, TCEQ will issue its confirmation that regulatory closure has been attained in the form of an NFA letter.

Section 207 of the DCRP provides the following protections to site owners eligible to participate in fund benefits:

> *If an owner or a person registered under [the DCRP] is eligible under this chapter to have corrective action costs paid by the fund, an administrative or judicial claim may not be made under state law against the owner or other person by or on behalf of this state or by any other person, except a political subdivision, to compel corrective action or seek recovery of the costs of corrective action that result from the release.*

In order for a new buyer of property that is enrolled in the DCRP to avail itself of the protections available under Section 207 of the DCRP, the new buyer will need to apply to succeed to the position of the seller that has been paying fees into the DCRP fund. If the seller has not been paying in the fund, the new owner will have to pay back fees and penalties in order to be eligible for fund benefits.

The DCRP has two main drawbacks. First, TCEQ will not have sufficient funding for investigative and remedial activities for all ranked sites. Consequently, it postpones corrective action at lower priority sites in order to make money available for higher priority sites and is not committed to taking a site to closure in every case. Secondly the Statute expires, by its terms, on September 1, 2021.

5. Subchapter T.

If property includes an enclosed structure over a closed municipal solid waste landfill, the property should have a development permit or registration relating to that enclosed structure. TCEQ will need to approve the transfer of the seller's obligations under the applicable permit or registration in order for the buyer to assume responsibility for those obligations. The buyer will want

to ensure that all documents and plans required under 30 Tex. Admin. Code § 330.961 are located at that site at the time of transfer.

IV. WRAP-UP.

Although the foregoing is not an exhaustive discussion of environmentally-related concerns of a buyer, we encounter the matters discussed above on a recurring basis. The take away is this: statutory and common law liability under applicable environmental law can create material exposures for a party acquiring an interest in real property. A buyer is well advised to carefully assess the potential environmental exposures presented at a property, to consider appropriate governmental regulatory programs that may provide comfort, and to utilize mechanisms such as remediation agreements, releases and indemnity provisions and other contractual risk allocation provisions, along with environmental insurance, to manage or mitigate the risks presented. Those risk management tools are highly fact specific, and the buyer's counsel should consider the available options and draft the contractual language carefully, since use of boilerplate language for any particular deal may not provide adequate protection for the buyer.

ATTACHMENT 1

PRELIMINARY ENVIRONMENTAL ISSUES CHECKLIST FOR REAL ESTATE[i] TRANSACTIONAL MATTER

1. Contact Information:

   Client Name: _____

   Client Contact: _____

   Address of Property: _____

   Adverse Parties: _____

2. What is client's connection to the site? (e.g., owner, tenant, prospective purchaser, etc.)

3. What are the known environmental conditions at the site?
   (a) What are the known contaminants?
   (b) How were the contaminants discovered?
   (c) Has the known contamination been delineated?
   (d) What are the potential sources of the contaminants?
      i. onsite
      ii. offsite
      iii. commingled
   (e) Is there an offsite impact of contamination?
   (f) Is the site currently or formerly enrolled in/subject to a regulatory program?

4. Are there potential claims for site conditions?

   (a) Have those claims been assigned?
   (b) Are statute of limitations issues involved?

5. Are there potential notification/reporting requirements relating to contaminants?
   (a) federal
   (b) state
   (c) local
   (d) lenders
   (e) contractual
   (f) tenants
   (g) adjoining property owners or tenants

6. Who are the potentially responsible parties for the conditions?
   (a) From whom is client purchasing or leasing the site?
   (b) Who are the former and current owners and operators at the site?
   (c) Who are the surrounding property owners and operators?

7. Are there contractual provisions that potentially apply to the conditions?
   (a) Purchase contract?
   (b) Leases?
   (c) Financing documents:
   (d) Licenses or access agreements?
   (e) Indemnities or releases?

8. Does client or another potentially responsible party have insurance?
   (a) Have the insurance companies been notified of any potential claims?

(b) Are copies of insurance policies available for review?

9. What reports for the site are available?
   (a) Has the client selected a consultant?
   (b) Which consultant prepared the reports?
   (c) If the consultant was not engaged by client, is there a reliance letter for the report?
   (d) What new reports are advisable?

10. Are there any contractual restrictions regarding?
   (a) Property access?
   (b) Subsurface investigation?
   (c) Information disclosure?

11. If the transaction involves operations (either ongoing or defunct at the property):
   (a) Are there existing environmental permits for the site?
   (b) What permits need to be transferred, terminated or obtained?
   (c) What is the history of offsite disposal?
   (d) Are there ongoing contractual obligations that run with the land (e.g. remediation obligations?

12. Is a compliance audit under state or federal law appropriate?

13. Is there a lender involved?

[i] *This checklist is intended to help identify some general information to gather from clients upon engagement for a new transactional matter. Not all the issues noted will be relevant to the matter, and there will be relevant matters that are not included on the checklist.*