STRATEGIES FOR ENVIRONMENTAL RISK MANAGEMENT

By Stephen F. Hilfiker, MS, CFEA, REPA

It all started with the Love Canal. William T. Love, a 19th Century entrepreneur, decided he was going to build a city from scratch. His plan was to generate hydroelectric power from the Niagara River. He built a one-mile long canal, ran out of money, and abandoned the project. The Hooker Chemical Company and other chemical companies used the canal between the 1920's and the 1950's as a toxic waste landfill. They sold the property for $1.00 to the Niagara Falls School Board in 1955. A school and a residential community were developed over the Love Canal. Numerous health problems accumulated and prompted Congress to pass the Comprehensive Environmental Response Compensation and Liability Act of 1980, better known as Superfund.

Environmental Laws

Superfund imposed strict, joint, several, and retroactive liability for pollution on property within the United States. This essentially means that they could find almost anyone involved with the property, at any time, liable for remediation costs **regardless of fault**. This law, and similar state laws that are based on the same principles, have made commercial real estate transactions far more complex over the last two decades. Numerous court cases have exacerbated the impact of these rules to the extent that impacted properties are difficult to finance and sell.

Over time, things always seem to balance out. We are approaching a balance between environmental protection and economic progress based on recent legislative amendments, increased risk tolerance, environmental insurance, developing technologies, and other risk management strategies described in this article. **Successful implementation of environmental risk management strategies, in many cases, will enable environmental risk management so that real estate transactions on impacted properties can close.** The purpose of this article is to introduce several environmental risk strategies to assist with real estate transactions. One of the primary hurdles to clear on the way to the closing table is financing for the buyer.

Lender Liability and Financing Impacted Properties

Several court cases, such as U.S. v. Maryland Bank and Trust, 1986, and the Fleet Factors Case, 1990, made liability for remediation costs a significant concern for lenders. Lenders had deep pockets, but in most cases did not contribute to or exacerbate contamination that existed on their collateral properties. Congress passed the Asset Conservation Act of 1996, an amendment to Superfund, to define permissible activities that lenders could perform without violating their secured creditor exemption. The Act essentially states that as long as the lender behaves as a lender and does not get involved in management of the operation, they will not be found liable for contamination that exists on properties used to secure loans.

The Asset Conservation Act provided some relief in that lenders are not as concerned about liability as they once were. However, the security of loans is still a risk for lenders if the collateral property is impacted. Diligent assessments and plans to either **maintain, restore, or**

insure property value are typically required by lenders and buyers to go forward with impacted property transactions.

To identify and quantify environmental risks, diligent environmental assessment services should be performed. Once the risks are defined, the following strategies can be employed to manage them.

Environmental Management (Maintain Value)

Investigating past and present environmental quality provides a good baseline. Requiring sound environmental management practices reduces the potential for future releases. All purchasers/lenders should consider environmental management practices to control future environmental quality. Environmental management plans are designed to prevent pollution. Storage, handling and disposal practices are outlined in detail. Containment and spill response are critical elements of the plan.

The Florida Department of Environmental Protection (FDEP) has used this approach in regulating petroleum and dry cleaner sites. Cleanup programs were established to provide financial assistance for eligible facilities with existing problems (not all sites are eligible). Florida Administrative Codes require secondary containment and compliance with waste management principles. Financial responsibility must be demonstrated. These rules and programs have offered a solution to existing concerns, and a method to prevent future concerns. On a much smaller scale, we can use the same approach when evaluating each property.

Cleanup Programs (Restore Value)

The most regulated facilities are dry cleaning, petroleum, and industrial facilities that utilize hazardous substances or generate hazardous waste. Florida, and many other states, has created petroleum and dry cleaning solvent cleanup programs that are funded by industry based taxes. The programs are designed to protect the environment by funding assessment and remediation at sites that are eligible for the programs. All of the programs are now closed, with the exception of the Petroleum Contamination Participation Program, which requires FDEP knowledge of a pre-1995 discharge. **Determining if a petroleum or dry cleaning site is eligible for cleanup funding, and if so, identifying how and when funds may be made available, is critical to risk management.**

Properties that are ineligible for the petroleum or dry cleaning programs, hazardous waste sites, industrial facilities, and other potentially impacted properties may be eligible for Brownfield Redevelopment Act incentives. “Brownfields”, in general terms, are potentially contaminated properties. Local governments can declare any property or group of properties to be designated Brownfield sites. **By following the procedures established in the Brownfield Redevelopment Act, property owners can take advantage of numerous regulatory and economic incentives provided through local, State, and federal governments.** The incentive for government is to return underutilized/abandoned properties to the tax base. The incentives for property owners include tax credits, low interest rate loans, money based on the number of employees working on the redeveloped property, and permitting leniency or waivers.

Florida Statutes Section 376.308(5) provides some administrative immunity from FDEP mandated assessment and remediation services on properties that are eligible for the cleanup programs. Owners of property that are eligible for the cleanup programs are not compelled to assess or clean up contamination on the eligible site until the property reaches priority status based on the hazard ranking scoring system set forth in the rules. Chapter 376 offers no immunity for third party lawsuits based on off-site migration of contaminants. So for properties that are eligible for cleanup programs, off-site migration and potential claims associated with third party liabilities represent the greatest concern for purchasers and lenders.

Off-site migration of contaminants is a source of liability that is very difficult to manage. A diligent assessment of the extent of off-site migration and/or an environmental insurance policy to protect against a third party lawsuit are typically necessary to adequately manage these concerns if off site migration of contaminated groundwater is extensive.

Environmental Insurance (Insure Value)

The environmental insurance market has emerged in the last few years. Environmental insurance is a very valuable tool that can be used to bring complicated transactions to a close. Decisions involving impacted properties have no financial basis unless the exposure associated with the impact can be determined. **Environmental insurance can be used to quantify risks.** The cost of premiums and deductibles can be included in the economic equations for investors and lenders to base decisions. There are several types of insurance that can be used to close impacted property transactions.

(1) Cost Cap/Remediation Cost Overrun Insurance
The cost of remediation can now be fixed based on these insurance policies. Using a remediation cost estimate, and factoring in the cost of insurance, the potential exposure can be determined.

(2) Remediation Warranty Insurance
This insurance protects owners against discovery of contaminants (new discoveries) after completion of remediation, or after a remedial action plan has been approved.

(3) Lender/Secured Creditor Policies
These policies provide coverage for lenders against default by a borrower caused by pollution conditions discovered at the site after closing. These policies pay the lesser of the outstanding loan balance or the cleanup costs. The lender policies typically do not protect anyone but the lender, and do not constitute due diligence. Borrowers (either purchasers or refinancing owners) should beware and not get a false sense of security from these policies. Government imposed or third party liabilities would still damage the welfare of the borrower in most cases.

(4) Real Property Transfer Liability Insurance
These policies provide coverage for third party or government-imposed cleanups when the requirement for such services is discovered after closing.

These descriptions are very general and the policies can be more or less extensive depending upon the needs of the insured, or the site-specific conditions that create the need for the insurance.

Determine Actual Value

Impacted properties have reduced value. **If the environmental impact can be quantified, the value of the property – including the impact – can be appraised.** Decisions regarding the purchase price, loan amount, loan to value, resale potential, and overall credit decisions can be based upon the adjusted value after investigating and quantifying the risk.

If lending decisions were made using corrected values from the outset, foreclosure pressures would not be as extreme because the outstanding balance would be less than the actual property value. A sale of impacted property based on corrected values is feasible. Numerous investor groups are affiliated with remediation companies, and actively pursue impacted properties based on adjusted values.

Diligent assessment, remediation cost estimation, and appraisal services will generally be necessary to quantify the risk. The costs of these services, and the reduced value may damage the interest of all parties to the transaction, but this approach should provide a more realistic baseline to value.

Indemnification

Indemnifications and warranties will always play a major role in real estate transactions. Seller indemnification and **escrow of cleanup funds still may be the easiest and most practical method** to transact property. But there are some flaws to this approach, primarily for the buyer.

Purchaser risks include the solvency of the seller, the scope of the indemnification, resale considerations, and the uncertainty of the overall cost of cleanup. For sellers, the federal government is typically not part of the transaction, and that small piece of legislation called Superfund that created this regulatory stew may not consider the resources of the country to be indemnified.

Conclusion

Each property has its own set of circumstances including the potential for pollution, eligibility status, extent of pollution, concentration and location of contaminants on the property, site specific hydrogeology, types of adjacent and nearby property land uses, financial security of the borrower, potential to insure against site specific risks, value of the property, and intended future land use of the subject property. All of these and other factors should be considered when preparing an effective risk management strategy for impacted properties.

Steve Hilfiker is president of Environmental Risk Management, Inc. (ERMI), a DEP petroleum cleanup contractor, Florida-licensed engineering firm and geology business, and environmental

forensic consulting firm. Steve is a former two-term president of the Florida Environmental Assessors Association, and can be reached through www.ermi.net or by calling 1-888-ENV-MGMT (1-888-368-6468). He is available for public speaking engagements to groups, organizations and conferences.