

Phase I Environmental Site Assessments *Seven Things Every Real Estate Professional Should Know*

Introduction

Phase I Environmental Site Assessments (“Phase I”) are a familiar component of due diligence in most real estate transactions. But all too often, a Phase I is perceived as just another check box on the list of necessary conditions to complete a feasibility study or satisfy a lender. To the contrary, a Phase I may provide valuable information, and assist the parties in identifying and allocating environmental risk within the context of the transaction. This article discusses key issues and considerations relevant to performing and effectively using the results of a Phase I.

Before spending \$2,000-4,000 on a Phase I, try answering the following questions:

1. What is a Phase I?
2. What does a Phase I *not* disclose?
3. Why should a Phase I be performed?
4. When should a Phase I be performed?
5. Who should prepare a Phase I?
6. How will Phase I standards change on November 1, 2006?
7. How can an attorney add value to a Phase I?

Real estate professionals (*i.e.* brokers, developers, attorneys, and investors) should be able to answer most, if not all, of these questions.

What is a Phase I?

In general terms, a Phase I is an inquiry into the current environmental condition of a property. It is intended to uncover evidence of past, present or potential releases of hazardous materials whose presence may result in cleanup liability, third-party liability for property damage, and/or third-party liability for bodily injury.

More specifically, a Phase I consists of the following elements:

- An inquiry by an environmental professional – The person performing and supervising the Phase I must possess a specified level of professional training or relevant experience.
- Interviews with past and present owners, operators, and occupants of the facility.
- Reviews of historical sources, such as chain of title documents, aerial photographs, building department records, and land-use records, to determine previous uses and occupancies of the real property.

- A search for recorded environmental clean-up liens against the facility.
- Review of government records, waste disposal records, storage tank records, hazardous waste records, and spill records concerning contamination at or near the facility.
- Visual inspections of the facility and adjoining properties.
- An inquiry regarding any specialized knowledge or experience on the part of the property owner.
- An inquiry regarding the relationship of the purchase price to the value of the property if the property was not contaminated.
- Commonly known or reasonably ascertainable information about the property.
- The degree of obviousness of the presence or likely presence of contamination at the property and the ability to detect the contamination by appropriate investigation.

As broad as these criteria appear, a Phase I is specifically limited in scope and, among other things, does not include intrusive investigation (*e.g.* soil and groundwater sampling). It is, therefore, just as important to know what a Phase I does *not* disclose as it is to know what it does disclose.

What a Phase I Does Not Disclose

A Phase I will not confirm the presence or absence of contamination, including asbestos and lead paint. Rather than confirming or quantifying conditions, a Phase I is intended to reveal evidence of past or present releases of hazardous materials. For example, a Phase I may identify staining adjacent to an aboveground storage tank, but it will not identify the chemical composition of the staining. In order to identify and quantify the condition, a Phase II is required.

A Phase I will not evaluate whether the property or business is in compliance with applicable environmental laws and has all required permits. The existence of environmental claims filed against the property or property owner is also outside of the scope of a Phase I.

Additionally, subsequent changes in environmental conditions will not be reflected in the Phase I. Because a Phase I is merely a “snapshot” of property conditions as they exist on the date of the report, the property’s conditions may change significantly from the time the report is prepared to the time it is received by the end user.

Why Should a Phase I Be Performed?

There are a number of legal and business reasons to perform a Phase I. First and foremost, a Phase I is a necessary element of a prospective purchaser’s due diligence. Environmental concerns may be subtle and not evident to laypersons. Even in instances where there is no obvious indication of potential problems (*e.g.* undeveloped property), it is prudent to conduct a Phase I.

Other reasons to perform a Phase I include:

- Defenses to cleanup liability – CERCLA (the Federal environmental law otherwise known as “Superfund”) provides certain defenses to cleanup liability if, among other things, the purchaser performs a Phase I prior to acquisition.
- Satisfying lender requirements – Virtually all lenders require that a Phase I be performed as condition of the loan.
- Seller due diligence – A prospective seller may want to identify adverse environmental conditions that might impact the timing and value of a transaction.
- Avoidance of delays and restrictions – Early identification of environmental issues assists the parties in negotiating appropriate and timely solutions to existing problems.

When Should A Phase I Be Performed

A Phase I should be conducted as early in the transaction as possible in order to identify issues that may have a material impact on timing and structure. Its timing, as is the case with other due diligence, is typically a point of negotiation between the seller and purchaser. The seller will likely seek to limit the time period in which a Phase I may be prepared by proposing a tightly defined feasibility study period. In contrast, most purchasers would prefer to identify any material environmental issues before signing the contract. In practice, the parties frequently agree that a Phase I will be performed once the property is under contract. Either way, the contract should clearly reflect the parties’ intentions and provide adequate time prior to settlement to address any issues uncovered by the Phase I.

Who Should Perform a Phase I?

Typically, the purchaser should retain an environmental consultant to perform a Phase I. The purchaser, in most cases, is assuming the risk of environmental problems and should be in control of the process. Moreover, Phase I reports prepared for the seller may downplay the significance of issues or lack any recommendations. If the purchaser cannot have a Phase I prepared and must rely on the seller’s Phase I, it is essential that the purchaser obtain the right to rely on the report. Most consultants will extend the right to rely on the report for a nominal fee.

How Will Phase I Standards Change on November 1, 2006

On November 1, 2006, the U.S. EPA’s All Appropriate Inquiry (“AAI”) rule goes into effect. AAI codifies specific criteria for Phase I investigations. While voluntary standards established by the American Society for Testing and Materials (“ASTM”) have existed for a number of years, the EPA’s AAI rule establishes more stringent criteria than the existing ASTM Phase I standard. Real estate professionals should be aware of the changes and, most importantly, ensure that they retain environmental consultants who are capable of complying with the new standards. A detailed summary of the new standards may be found at: http://www.epa.gov/brownfields/aai/compare_astm.pdf.

How Can an Attorney Add Value to a Phase I?

“I’ve read the executive summary – the report is clean.” I wish that I had a dollar for every time I have heard that line, only to discover material issues lurking in the body of the Phase I report. Phase I

reports may appear straightforward and easy to draw conclusions from, but there are a number of subtleties that may reveal, or fail to reveal, material environmental issues. For example:

- Reports may be biased in subtle ways - As discussed above, reports prepared for sellers may have subtle biases that downplay potentially significant issues, and may also lack conclusions or recommendations.
- The report may be out of date - Phase I reports have a shelf life of six months. After six months, Phase I reports do not meet the EPA's criteria for All Appropriate Inquiry and may not be used as a defense to statutory cleanup liability.
- The quality of reports varies dramatically - It pays to hire a reputable consultant. Spending an extra \$1,500 on a thorough Phase I performed by an experienced consultant may save tens of thousands of dollars down the road.
- Portions of the report may be missing - Phase I reports (including attachments) may be over 100 pages. If the seller is providing the report, it may just provide the narrative portion of the report. The attachments may contain material information, including prior reports, correspondence from regulatory agencies, and other important information.

Moreover, the consultant's contract may be deficient. The standard terms and conditions offered by many consultants are often inadequate with broad limitations on liability, scant information on insurance, and other objectionable terms. It is well worth the effort to have an attorney review the contract and negotiate better terms.

Conclusion

A Phase I report is a useful due diligence tool in real estate transactions if properly used, understood, and applied. A basic understanding of the key elements, limitations, and common pitfalls is necessary to properly use this tool.

The above outline is intended only as a broad overview of Phase I Environmental Site Assessments and does not constitute legal advice. If you have questions about Phase I Environmental Site Assessments or if you would like assistance in obtaining and reviewing one, please contact Richard F. Waddington, Esquire, of Whiteford, Taylor & Preston, LLP at (410) 347.8712 or rwaddington@wtplaw.com.

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