What Level of Due Diligence Is Enough?

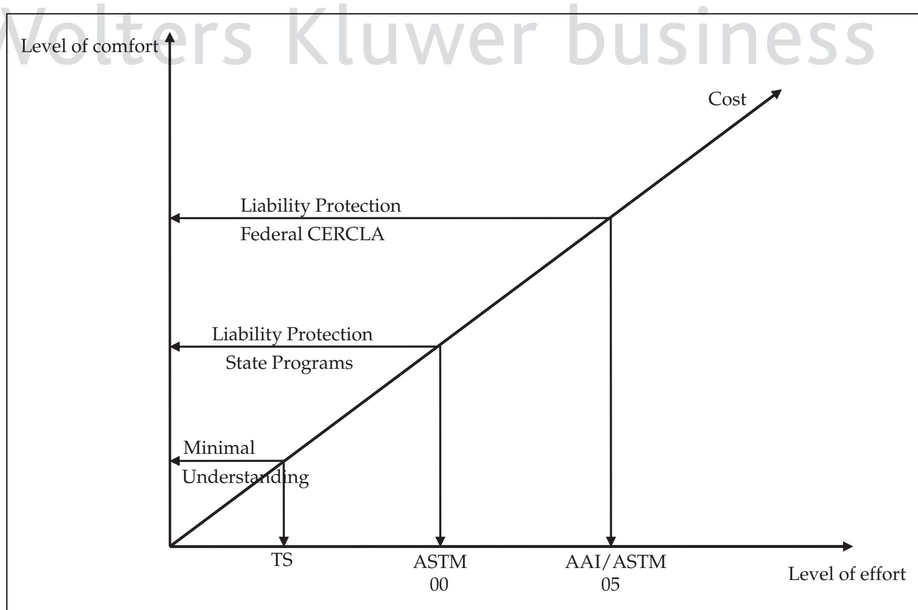
By Samuel W. Butcher and Susan A. Bernstein

A framework to evaluate costs and risks.

Environmental due diligence has been an integral part of a lender's decision-making process when considering real estate transactions since the promulgation of many federal environmental regulations in the 1970s. Knowledge of environmental conditions, whether environmental contamination is or could be present, or the lack of such knowledge, can be one of the larger risk factors when considering a loan, foreclosure or purchase. In Massachusetts, for example, lenders commonly request a "21E," referring to the state environmental cleanup regulations, to provide the necessary information in order to evaluate environmental conditions and potential risks. A similar practice occurs in other states where other regulations are applicable.

Recently, the U.S. Environmental Protection Agency (EPA) finalized its "*All Appropriate Inquiry*" (AAI) standard, spelling out the level of effort necessary for liability protection under federal law. So the question arises: How did AAI change the due-diligence landscape, and what level of environmental due diligence is necessary? The answer is that there are some significant differences between what was once considered an appropriate level of due diligence and a site investigation that comports to the AAI standard. But whether you need to meet the AAI standard depends on a lot of factors, including what your bank considers an appropriate trade-off between costs of due diligence and environmental risks that can affect collateral value. This concept is illustrated in what we refer to as the due diligence continuum.

Exhibit 1



Past Practices

The AAI standard came about because the EPA needed a specific standard by which a prospective purchaser of a property could establish liability protection from the federal Comprehensive Environmental Response Compensation and Liability

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Act (CERCLA, or "Superfund") for three major categories: innocent landowners,[1] *bona fide* prospective purchasers (BFPPs)[2] and contiguous landowners.[3] A fourth category, applicable to those entities that are recipients of EPA brownfields grants, is also covered by the new standard. Before the recent amendments to CERCLA, potential buyers could establish liability protection under CERCLA if they could demonstrate that they were innocent landowners. Such liability protection prevented the federal government from suing the buyers of property for cleanup of environmental contamination if they could demonstrate that they exercised due care with respect to the hazardous substance concerned.[4] The amendments mandate the establishment of certain investigative requirements that buyers must follow *prior to* purchase to demonstrate that they have completed appropriate due diligence, that is, followed the AAI standard. The AAI standard became effective November 1, 2006. Before the amendments and development of the AAI standard, buyers had no clear sense of the level of effort necessary to demonstrate that they had completed adequate due diligence for assuring federal liability protection. The AAI standard clarifies what needs to be done. Under AAI, prospective purchasers will want to establish themselves as BFPPs.

AAI is intended to assure liability protection with respect to federal regulations for the cleanup of hazardous materials, not state regulations and not petroleum releases.

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Specific additional requirements include, but are not limited to, broadening the scope of environmental due diligence activities and documenting significant data gaps or uncertainties, including interviewing past and current owners or occupants and interviewing adjacent landowners if the subject property is abandoned.

With the AAI regulations in place, potential buyers of, and lenders for, environmentally impaired properties or potentially impaired properties know exactly what they need to do to ensure that the EPA will not sue them for damages or force them into costly environmental cleanup of hazardous materials under CERCLA. AAI is intended to assure liability protection with respect to federal regulations for the cleanup of hazardous materials, not state regulations and not petroleum releases.

Massachusetts General Laws (MGL), chapter 21E (21E), the Massachusetts Oil and Hazardous Material Release Prevention and Response Act (often referred to as the state Superfund act) mimics CERCLA in most respects. Many other states, including Connecticut with its Transfer Act and Rhode Island with its Remediation Regulations, have similar provisions. Like the federal counterpart, the Massachusetts law may require owners or operators of properties contaminated with hazardous materials to complete necessary cleanup. Also like CERCLA, 21E provides liability protections. Unlike its federal counterpart, 21E also incorporates contamination associated with releases of oil (for example, petroleum), which are excluded by CERCLA. Where CERCLA exempts owners who completed adequate due diligence, BFPPs who completed AAI, 21E exempts "eligible persons"[5] who completed an adequate level of due diligence.

Though the CERCLA amendments and the AAI standard clarify the level of effort necessary to obtain liability protection under CERCLA, there is no similar standard to demonstrate that one is an eligible person. Case law has established some guidance with respect to how much investigation is enough investigation; when knowledge occurs; the obligations for owners, operators and prospective purchasers; and what level of cleanup is necessary. Though there are some general rules of thumb, there does not yet appear to be any state equivalent to the AAI standard.

In the absence of a promulgated standard for site investigation, lenders and property buyers in Massachusetts typically contact their environmental consultants to perform a "21E investigation," as well as hire an attorney knowledgeable about the 21E obligations and liabilities. This investigation has become industry shorthand for the American Society for Testing and Materials (ASTM) Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process (previously ASTM E-1527-00, updated to ASTM E-1527-05, to coincide with AAI requirements), known as a "Phase I," or a similar investigation called a "Transaction Screen" (TS) (ASTM E-1528-00). Typically,

lenders, buyers, environmental consultants and attorneys work together to determine whether a Phase I or a TS represents the appropriate level of investigation. The degree of due diligence, which affects the cost and amount of time spent, depends upon the condition and potential use(s) of the property being investigated and the likelihood that environmental contamination may be present, among other factors. The purpose of both the Phase I and the TS is to identify Recognized Environmental Conditions (RECs), which are categorized as those environmental conditions, including the storage of oil or hazardous substances, that could be subject to an enforcement action if brought to the attention of an appropriate government agency. In other words, the Phase I and TS are intended to identify conditions at the property that could pose a liability in the event a government entity were to take enforcement action. Before the AAI changed, the ASTM Phase I and TS were the de facto standard of care for asserting liability protection under CERCLA and similar state laws and regulations like 21E. The Phase I and TS remain the de facto standard of care for asserting liability protection and the eligible person status (or similar term) under most state regulations, but now broadened to incorporate changes to comply with AAI.

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Changing Regulations—The AAI and New ASTM Standards

Promulgation of the AAI provisions created the impetus for ASTM to also revise its standard with a new standard for Phase I Site Assessments (ASTM 1527-05), also effective in November 2006. The ASTM 1527-05 mirrors the requirements for AAI and increases the depth of the inquiry and investigation compared to the previous Phase I standard. Most notably, the new standard accomplishes the following:

- Defines an environmental professional and establishes both the credential for and level of involvement required by the environmental professional
- Requires interviews with prior owners and with neighbors of abandoned properties, when the owner of the property cannot be located
- Expands the records search requirements to include a title search (which would typically be performed by the buyer's attorney and likely required by the lender)
- Expands the requirements of an environmental professional to evaluate the purchase price of the property to determine whether the price reflects environmental impairment
- Requires visual inspection of adjoining properties from the principal property
- Requires documentation of any special knowledge of the property by prospective purchasers
- Requires that prospective purchasers identify and document data gaps
- Sets out continuing and ongoing obligations
- Requires that prospective purchasers take reasonable steps

While the EPA estimates that the cost associated with the increased level of effort to meet the new ASTM standard and demonstrate AAI will be insignificant, between $50 and $60, environmental consultants and attorneys agree that the difference in the level of effort associated with ASTM 1527-00 (the previous standard) and the revised standard (ASTM 1527-05) will be significantly more, as will the level of protection to the prospective purchaser. We estimate an increase of $100 to $500 more than the preexisting ASTM 1527-00, which represents between two and five hours of additional time in terms of investigating, analyzing and reporting. If site investigations are conducted in strict accordance with the new ASTM standard for a Phase I Site Assessment, the provisions for BFPPs will be considered met, and liability protection is effectively assured. Similarly, it is highly likely that completion of a Phase I in accordance with the new ASTM standard will satisfy the requirements for eligible-person status under most state laws and regulations, though only case law or new regulations will say this with certainty.

The Due-Diligence Continuum

Completion of a Phase I Site Assessment in accordance with the ASTM standard will likely assure the lender and the prospective purchaser of liability protection under CERCLA and 21E. But recall that liability protection under CERCLA is limited to hazardous materials and specifically excludes petroleum and oil. The eligible person status under 21E affords liability protection under Massachusetts laws and covers hazardous materials and oil, although the

oil protection only exists in certain circumstances.[6] Certainly in Massachusetts, where there is an active state environmental agency, the Massachusetts Department of Environmental Protection (DEP), this liability protection is worth something.

But the vast majority of real estate transactions involve properties with little or no environmental impairment. As such, it is extremely unlikely that federal or state liability protection with respect to releases of oil or hazardous material would play a significant role in the decision-making process. The liability protection is a secondary concern. The primary concern with respect to environmental conditions at most properties, and the focus of most due-diligence activities, is the degree to which an environmental condition will interfere with cash flow or affect the value of the property. Lenders are primarily concerned with the cost to resell a property if they have to foreclose. They want to be as certain as possible that any potential environmental cleanup will not interfere with cash flow in the event a borrower might default on a loan.

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In the words of one banker, "The bank gains nothing from an AAI report, because we are completing our due diligence review for entirely different reasons—more to evaluate and quantify risk rather than to qualify for exemptions from liability." Further, because liability provisions have already been written into regulations protecting lenders who are not actively involved in the management of the property (secured lender exemptions) and who do not hold onto properties after foreclosure, many bankers believe there is little need for a due-diligence investigation that meets AAI.

These lenders need to manage the risk/cost tradeoff presented by different levels of due diligence. As Exhibit 1, the due diligence continuum, shows, increased levels of due diligence (along the horizontal axis)—from the traditional TS to the ASTM Phase I (2000) to the revised ASTM standard, which comports to the AAI standard—are associated with increased cost for due diligence. Depending upon the level of effort, one gains liability protection, first at the state level and, with increased investigation, then at the federal level as a BFPP. At specific level-of-effort milestones, certain liability protections thresholds are achieved.

Lenders who are less concerned about specific liability protection will have different levels of comfort requirements depending upon the size of the loan, whether or not they already hold title, their relationship with the borrower and many other considerations. If liability protection is less important, lenders may be free to determine what level of comfort is appropriate to their particular needs. Where they need to end up on the level-of-comfort axis will dictate where they start on the level-of-effort axis and how much the due-diligence process costs. Lenders may not recognize the same due-diligence milestones that AAI does. Instead, they may fall along a due-diligence continuum, where some lenders achieve an adequate level of comfort with relatively little due diligence and others require more work.

Some banks are revising their site assessment requirements to reflect the changing due-diligence landscape. One national bank recently revised its guidelines; though AAI investigations will be required in some cases, significantly less due diligence will be necessary in other situations. This bank has determined that an adequate level of comfort is achievable with a reduced level of effort and that, in many situations, the liability protection afforded by AAI is not consequential.

But AAI raises the bar, putting greater onus on the entity to become fully informed about the status of a property as well as to seek liability protection. A lender or prospective purchaser may not think that it needs the expanded level of inquiry that will be required by the new AAI and ASTM requirements. These standards, however, will become the new baseline for establishing liability protection. The additional requirements will likely add important protections for all parties. With stronger government incentives to redevelop previously used and often contaminated properties, AAI may not be the overkill it might otherwise be thought to be.

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Due Diligence, Loan by Loan, Property by Property

Lenders should continue to require due-diligence investigations to determine whether properties are contaminated *before* accepting these properties as collateral, *before* taking title to these properties or when making foreclosure decisions. In most cases, it is probably not necessary to complete an investigation that meets the full AAI standards. Rather, the goal of the due-diligence work should be to gain a level of comfort with respect to the property and its potential for environmental liability. The level of due diligence will vary according to the risk tolerance of the lenders. In most cases, an adequate level of comfort can be obtained after completing a Phase I site investigation consistent with the scope of the "old" Phase I standard; in many cases, only a TS will be necessary. The lenders will decide where they fall on the due-diligence continuum.

Whether you need to actually complete a full-fledged AAI investigation appears to hinge on whether you are seeking liability protection under CERCLA. It is clear that there will be no CERCLA protection without AAI.

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Endnotes

1 Defined as an unknowing purchaser who did not know or had no reason to know that hazardous substances were released on the property. *See* CERCLA §107(b)(3) and §101(35).

2 BFPP is defined as an entity that must meet the requirements articulated in CERCLA §101(40) and §107(r), including (1) purchased the property *after* January 11, 2002; (2) may purchase with knowledge of contamination after performing all appropriate inquiries, provided it meets the following: acquired the property after all disposal of hazardous substances at the property ceased; provided all legally required notices with respect to the discovery or release of any hazardous substances at the property; exercised appropriate care by taking reasonable steps to stop continuing releases and prevent any future threats; fully cooperated and assisted persons authorized to conduct response actions and natural resource restorations; complied with land restrictions established or relied on in connection with a response action; did not impede the effectiveness or integrity of any institutional controls; complied with any CERCLA requests for information or administrative subpoena; and not being potentially liable or affiliated with any other person who is potentially liable for response costs for addressing releases at the property. This definition has some of the characteristics of the "eligible person" under 21E, defined elsewhere in this article.

3 CERCLA §107(q)(1)(A) protects innocent victims against releases that may have occurred at contiguous properties owned by someone else. This definition has some of the characteristics of the "downgradient property status" under 21E.

4 *See* CERCLA §107[b][3][a].

5 "Eligible person" is defined in 21E as an owner or operator of a site or portion thereof from or at which there is or has been a release of oil or hazardous materials who would otherwise be liable under the strict liability portion of the statute but who did not cause or contribute to the release of oil or hazardous material from or at the site and did not own or operate the site at the time of the release.

6 *See* c. 21E, §5(a)(1) and §(5).

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