Environmental Update

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10 Things to Remember About Phase I Environmental Site Assessments

By David E. Roth and Molly Loughney Melius

During the past few months, there have been encouraging signs that the United States economy has begun to emerge from the recession that, at least according to the National Bureau of Economic Research, began in December 2007. As previously frozen cash reserves stockpiled by many businesses begin to thaw, the pace of acquisitions has begun to quicken. For environmental lawyers, the mobilization of cash and the reinvigoration of the transactional market translates into a sudden and welcome flow of environmental due diligence requests and responses and, in particular, a rush of Phase I Environmental Site Assessments (also referred to simply as "Phase I's"). With these Phase I's have come a variety of related issues—some new and some old—that can complicate or, in a worst case, derail a transaction. In light of this, now seems an appropriate time to reflect upon ten issues we encounter in the Phase I process.

1. The Commoditization of Phase I's: One consequence of the residential and commercial housing market contraction was a corresponding contraction in the amount of environmental consulting work available. Because of this decline in available work and because Phase I's often are the portal to more lucrative invasive site investigation and remediation work the competition amongst consultants to get Phase I work has become super-heated. This competition can translate into brutal price compression. We have seen instances of consulting firms submitting Phase I bids for as low as $1,000. By way of comparison, most ASTM E 1527-05 Phase I's fall in the $2,000-$3,000 range. While lower prices are ordinarily a positive market-place development for consumers, the problem posed in this instance is that some consultants sacrifice quality to achieve lower prices. Phase I's are, at a certain level, an exercise in thoroughness—the consultant must not only visit the site and interview the owner, but also study historical Sanborn maps, review agency files, and even peruse dusty old phone books at local libraries. When corners are cut to reduce costs, important facts can be missed. There is wisdom in the maxim that "a deal that's too good to be true is too good to be true."

2. Consultant Liability: As consultants continue to face cost pressure on Phase I work, they are also wrestling with a corresponding realization that, for work that may net them only a few hundred dollars of profit, they are potentially assuming millions of dollars of liability exposure. A Phase I is a buyer's basic summary of the environmental condition of a piece of property. In fact, in some cases, the Phase I is the only substantive environmental due diligence conducted by a potential acquirer. Accordingly, if the Phase I fails to accurately assess the environmental condition of the property, the acquirer may well look to the consultant for compensation. The claimed compensation can include not only the reduction in value caused by the environmental condition, but also costs of remediation and more abstract forms of damages such as lost profits or lost opportunity costs. Faced with a perceived imbalance between the profitability of

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the work and the scope of exposure, many consultants are aggressively seeking to contractually limit their potential liabilities to their clients. Caps of $1,000,000 or $100,000 are common as are categorical exclusions of special, consequential, and punitive damages. Another approach is to cap the liability at a relatively low number (such as $10,000 or $50,000), but to allow for an increase to the consultant's insurance limits if an additional fee is paid by the customer. In such instances, we almost always encourage the client to opt for the "buy up." In rare cases, a consultant may instead seek to cap its damages at the lesser of a fixed amount or the amount paid to it by the client for the Phase I services. This effectively establishes an extraordinary low cap—sometimes as low as $1,500. We encourage clients to be mindful of the various ways consultants may limit their liability and to closely review the Phase I contract with the consultant to see whether modifications to the contract are appropriate.

3. The Rise of "Hybrid" Phase I's: Particularly in the commercial real estate development arena, developers rely upon the presence of anchor tenants to ensure profitability. With the economic downturn, the importance of anchor tenants has only grown. Anchor tenants are not unaware of this increased leverage and often use it to demand, among other things, extremely robust environmental due diligence, often including extensive environmental testing regardless of whether recognized environmental conditions are identified by a more traditional Phase I. Indeed, the relative positions of the parties in negotiations like this are often so disparate that there is virtually no room to negotiate reduced testing—the anchor tenant simply says "take it or leave it." Accordingly, when advising developer clients, we often suggest they undertake a more comprehensive initial investigation to anticipate the tenant's demands. The goal is to avoid a situation where a developer receives a clean Phase I, closes on the property, and then subsequent testing ordered by the anchor tenant identifies environmental issues. In a worst case, this could strand the developer with reporting and remediation obligations but without an anchor tenant.

4. Avoiding Over-Reliance on Phase I's—Assessing Non-Scope Issues: A Phase I is an important part of a prospective purchaser's environmental due diligence, but it is not the only component of an effective environmental due diligence. The Phase I follows a relatively rigid standard adopted by ASTM that is designed to provide a fairly comprehensive snapshot of the environmental condition of the property, but it does not cover everything. For example, wetlands, asbestos-containing material, lead-based paint, and other matters are not within the ordinary scope of a Phase I. And, of course, the Phase I does not include invasive testing. Even before the Phase I investigation begins, the potential acquirer, environmental counsel, and the environmental consultant should meet to design a holistic review that conforms to the nature of the property. These discussions need not be extensive, but a little preparation on the front end can pay significant dividends on the back end.

5. Time, Time, Time—Allowing Sufficient Time for Environmental Due Diligence: One of the most frustrating experiences for an environmental lawyer or consultant is being told about an acquisition ten days before closing and being asked to perform a Phase I and adequate environmental diligence in that time. Even the most dedicated environmental consultant cannot do a Phase I overnight. The site must be visited, people must be interviewed, letters must be sent to government agencies, and a dozen other things must also occur. Some of these steps are completely controlled by the consultant, but others require the cooperation of third parties. If pushed, a consultant may be able to prepare a Phase I in a week or a matter of days; however, the price of achieving such speed is missing information in the Phase I (referred to as "data gaps"). The more data gaps that are present, the weaker the Phase I is. If too many data gaps are present, and the consultant concludes that those gaps have a significant impact on its findings, the client may not be able to avail itself of certain statutory defenses to liability. Equally important, the Phase I may omit important information that could influence the client's decision to purchase the property or its calculation of an appropriate purchase price. Moreover, even if the Phase I is completed in time, there almost certainly will not be enough time to do any follow-up testing recommended by the Phase I. To avoid these problems, clients should budget appropriate time for environmental due diligence.

6. Timing, Timing, Timing—"Stale" Phase I's: Having argued for early commencement of environmental due diligence, it is more than a little ironic to now point out that starting due diligence too early can lead to problems as well. In some transactions, a Phase I is prepared as one of the first steps in the due diligence process. Then, negotiations may drag on, a purchase agreement may be signed providing for a subsequent closing date, and the pre-closing matters may bog down causing still more delays. As a result, months pass before the actual closing date arrives. Unfortunately, a Phase I has a "shelf life" under the applicable federal regulations. Specifically, certain elements of the Phase I must be conducted or updated within 180 days of the closing. Given that these elements are some of the

primary components of the Phase I, many purchasers simply elect to get a completely new Phase I if the 180-day window has closed. And, of course, obtaining the new Phase I or the updated portions of an existing Phase I takes time (see above) and cannot be done the day before closing. In some instances, due to multiple delays, a Phase I may need to be redone three times before closing. There simply is no way around it.

7. The "User Questionnaire" Confusion: Many clients looking to acquire property complain that the environmental consultant mistakenly sent them a questionnaire to complete. "Why," they ask, "do we have to fill out a questionnaire about the environmental condition of the property? That's why we hired the consultant!" The short answer is that the questionnaire comes directly from the ASTM E1527-05 Standard and that the federal regulations require the user of the questionnaire (i.e., the prospective purchaser) to consider their own knowledge in connection with the inquiry concerning the property. Failure to undertake this internal inquiry can preclude the user from taking advantage of the statutory defenses. Put simply: it's important. The regulations do not require the consultant to receive a copy of the user questionnaire (the ASTM Standard, on the other hand, does, but that's a topic for a future article) but failure to provide this to the consultant can result in the inclusion of some problematic language in the final report that appears to question whether the user ever made the appropriate internal inquiry. From a record-keeping perspective, it is often easier to give the questionnaire to the consultant so that it can be incorporated into the final version of the Phase I. There are a variety of more specific issues raised by the questionnaire itself, but it is beyond the scope of this discussion to fully address them.

8. Lender Involvement: As the credit market has begun to thaw, some lenders have become increasingly involved in the environmental due diligence process for acquisitions they are financing. In some instances, lenders even insist on having their own consultant prepare a Phase I where the purchaser has already had such a report prepared. In order to avoid last minute problems, acquirers relying on financing should discuss with their lender the scope of environmental due diligence early in the process and obtain (as complete as possible an understanding) of the lender's position on environmental issues. It may also be advisable to select a Phase I consultant acceptable to the lender. Such coordination can reduce the amount of redundant environmental due diligence.

9. Obtaining Draft Phase I's: Once a Phase I is finalized, it has an independent existence that can either cause problems or make life easier in the future. And, while Phase I's should follow the ASTM E1527-05 Standard and applicable federal regulations, there is still room for a certain amount of discretion and subjectivity. For this reason, clients should obtain a draft of the Phase I from the consultant before it is finalized. This offers the client (and counsel) the opportunity to review the Phase I and negotiate with the consultant the modification of any language that the client finds objectionable. Some consultants are more willing than others to engage in discussions like this, but there is little downside to at least broaching the issue with the consultant.

10. Reliance Letters: One question that arises from time to time is whether a purchaser should accept a Phase I conducted by the seller's environmental consultant in lieu of having their own done. There are a variety of perspectives on this issue, but it's an issue that can only really be resolved in conjunction with the specific facts and circumstances of the situation. If the buyer elects to use a Phase I prepared by the seller's environmental consultant, the buyer should be certain that it is entitled to rely upon the findings in the Phase I. Ordinarily, there is language of limitation in a Phase I that makes clear that only the party to whom it is issued may rely upon it. Most consultants will address this by providing the buyer with a "reliance letter" that allows the buyer to rely upon the Phase I as if it had been addressed to them. The buyer should make sure that, in addition to obtaining the reliance letter, it also completes a user questionnaire concerning the property in order to assure itself of the benefit of the statutory defenses requiring all appropriate inquiry.

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The Phase I is an essential tool for evaluating the environmental condition of real property. Done correctly, the report can also insulate a buyer from certain types of environmental liability associated with the property. Purchasers should, however, not take the Phase I for granted but should devote appropriate time to timing, ordering, structuring, reviewing, and evaluating the report. Failure to adequately account for any of the steps in the process could result in significant adverse consequences for a purchaser. As the market continues (we hope) to improve and the pace of acquisitions increases, environmental due diligence should not be sacrificed in order to accommodate aggressive schedules and the inevitable "need for speed."

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David is a partner in the firm's Environmental & Toxic Tort practice group and is based in the firm's Birmingham office. David is a frequent author and speaker on environmental issues. He is listed in *Best Lawyers in America* for Environmental Law and has been included in *Alabama Super Lawyers* for Environmental. He is a member of the ASTM E1527 Task Group.

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