By Larry Schnapf

Hiring The Phase 1 Environmental Consultant

This installment discusses common contractual issues to consider when hiring an environmental consultant to perform a Phase 1 Environmental Site Assessment.

When hiring an environmental consultant, clients are often asked to execute an engagement letter that typically addresses the pricing for the Phase 1 and other logistical information. Attached to the engagement letter will be what often looks like a pre-printed form of terms and conditions that govern the performance of the services to be provided by the consulting firm.

Clients rarely examine the standard terms since they tend to focus on the price of the Phase 1 as well as timing for the delivery of the report. However, it is critically important that the terms and conditions provisions be carefully reviewed before executing the engagement letter because the boilerplate language can severely restrict the rights of the client in any dispute with the consultant. This article will review the key contractual issues that should be considered when retaining the consultant.

Scope Of The Phase 1

It is important for a property owner to understand that a standard Phase 1 is not a comprehensive or exhaustive investigation of all of the possible environmental conditions that might exist at a particular property. Likewise, a standard Phase 1 ESA is also not an environmental audit that examines compliance with state

Lawrence P. Schnapf is the principal of Schnapf LLC. He has over 25 years of national environmental experience with Fortune 500 corporations and a number of major New York-based law firms. He is also an adjunct professor of environmental law at New York Law School and a member of the faculty of the Center for Real Estate Studies at New York Law School. Larry has extensive experience performing environmental due diligence and negotiating environmental issues associated with corporate acquisitions, commercial lending and financing, workouts and bankruptcy, real estate transactions and brownfield redevelopment. He has counseled corporate and industrial clients on compliance with the regulatory requirements of federal and state environmental laws such as RCRA, CWA, CAA and their state counterparts, has represented clients in federal and state environmental litigation, enforcement matters, administrative proceedings and CERCLA private cost recovery actions, and has assisted clients in developing corporate environmental compliance procedures. He has served as chair of the Environmental, Energy and Resources Committee of the Business Law Section of the ABA, and co-chairs both the NYSBA Brownfield Task Force and the NYSBA Hazardous Site Remediation Committee. He can be reached at larry@schnapflaw.com.

and federal environmental laws. Indeed, the American Society for Testing and Materials (now called "ASTM") has developed standards for performing environmental compliance audits. *See* E2107-06 *Standard Practice for Environmental Regulatory Compliance Audits. See also* E2365-05 *Guide for Environmental Compliance Performance Assessments*.)

Instead, a Phase 1 ESA has the limited purpose of identifying the presence or potential presence of hazardous substances at a property so that the party ordering the report (the "user") to satisfy the "all appropriate inquiries" ("AAI") element that is necessary to qualify for one of the landowner liability protections available under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), 42 U.S.C. 9601 et seq., and many state laws. The CERCLA landowner liability protections are the Innocent Landowner ("ILO") of 42 U.S.C. §9601(35), the Bona Fide Prospective Purchaser ("BFPP") of 42 U.S.C. §9601(40) and the Contiguous Property Owner ("CPO") of 42 U.S.C. §9607(q). The Third Party Defense of 42 U.S.C. §9607(b)(3) is another important defense to liability but does not require performance of a pre-acquisition AAI-compliant investigation to assert the defense. For more complete discussion of these defenses, see Schnapf *EPA's All Appropriate Inquires Rule,* which appeared in the January 2007 issue of The Practical Real Estate Lawyer.

There may be other reasons why a property owner may perform an environmental site assessment. The parties to a transaction can use the information to help negotiate an appropriate price for the property. A purchaser can also use the information to "draw a white line" around the facility to show what conditions existed before the closing. Sellers are increasingly performing pre-marketing due diligence to pre-position a property as well as to expedite the due diligence process.

The ASTM *Standard Practice for Environmental Site Assessments: Phase 1 Environmental Site Assessment Process* (ASTM E1527) has become the accepted standard for Phase 1 reports. The 2002 CERCLA Amendments provided that the ASTM E1527 would satisfy the AAI requirement until EPA promulgated its own AAI rule. 42 U.S.C. §9601(35)(B)(iv). EPA "All Appropriate Inquires" (40 C.F.R. Part 312) became effective on November 1, 2006. On May 9, 2003, EPA published a final rule clarifying that for the purposes of achieving the all appropriate inquiries standards of CERCLA, and until the effective date of the EPA AAI rule, persons who purchase property on or after May 31, 1997 could use either the procedures provided in ASTM E1527-2000, or the ASTM E1527-97 set forth in the 2002 CERCLA Amendments. *See* 68 Fed. Reg. 24,888.)

Note that instead of referring to the CERCLA statutory term "Release," ASTM E1527 uses the term "Recognized Environmental Condition" ("REC"). ASTM E1527-05 defines a REC as: "the presence or likely presence of any hazardous substances or petroleum products on a property under conditions that indicate an existing release, a past release, or a material threat of a [future] release of any hazardous substances or petroleum products into structures on the property or into the ground, ground water, or surface water of the property." *See* ASTM E1527-5 §3.2.74. The definition goes on to state that the term is not intended to include "*de minimis* conditions that generally do not present a threat to public health or the environment and that generally would not be the subject of an enforcement action if brought to the attention of appropriate governmental agencies. Conditions determined to be *de minimis* are not recognized environmental conditions." The person seeking to use ASTM E1527 to qualify for one of the CERCLA LLPs is known as the "user." See ASTM E1527-5 §3.2.93. The "user" has specific obligations to satisfy the requirements of ASTM E1527-05 and AAI.

Many lenders require consultants to evaluate issues that go beyond those that would qualify as a REC. (These are referred to as "non-scope items.") Indeed, section 13 of ASTM E1527-05 contains a

non-exhaustive list of issues that could impact commercial real estate but that are not required to satisfy the AAI Rule. If a user (i.e., property owner, purchaser, lender, property manager) wants to have one or more of these non-scope items addressed in the ESA, they must tell the environment consultant and then ensure that the additional non-scope items are included in the engagement letter. These considerations include asbestos-containing materials, radon, lead in drinking water, lead-based paint, wetlands, endangered species, regulatory compliance, ecological resources, industrial hygiene and indoor air quality, health and safety, power lines and electromagnetic fields, and cultural and historical resources.

Many property owners simply rely on Phase 1 ESA reports that are ordered by the lender that is financing the particular transaction. As we discussed in a prior column (*How Phase 1 Reports Can Hurt Your Client,* November 2011), the lenders may have different risk tolerances than users. As a result, a property owner should independently evaluate the scope of the proposed Phase 1 that is ordered by its lender to confirm that the proposed Phase 1 will meet the needs of the property owner. In some cases, the property owner may want to add certain non-scope items to the scope of work. Moreover, the user should not assume that a property does not have any environmental issues simply because a Phase 1 report is acceptable to a lender. This is because the Phase 1 ESA is just one component of a credit analysis performed by a lender. For example, a Phase 1 might identify environmental issues that a borrower may have to incur costs to address but the lender might be comfortable based on the credit of the borrower or other credit enhancements.

Insurance

The consultant should be required to maintain the following types and minimum amounts of insurance coverage: Professional Liability of $1 million per claim; Comprehensive General Liability $1 million per occurrence for damage to property; Compensation and Statutorily Required Amounts, Employer's Liability, $500,000 per person; and Automobile Liability of $1 million per occurrence for bodily injury; $1 million per occurrence for damage to property. All insurance policies should be provided by an insurer rated at least "AA" by AM Best & Company. All insurance policies should be non-cancelable, except upon 30 days' advance written notice to the client. The consultant should be required to arrange for replacement insurance before cancellation of any insurance policy. The consultant should be required to provide to the client certificates evidencing all lines of insurance to client before commencement of any work. It is recommended that the client be made an additional insured on the Commercial General and Automobile Liability insurance policies.

Limitation Of liability ("LOL")

Many consultants typically seek to limit liability for negligence or breach of contract claims to the amount of the fee for the Phase 1 ESA though some provide for higher liability caps ranging from $50,000 to $100,000. If the client has negotiated the insurance limits discussed above, the client should try to increase the liability cap to the amount of the insurance limits, especially when there are suspected environmental issues at the property.

It should be noted, though, that even if a client is able to increase the liability limit to the amount of the consultant's insurance coverage, this does not necessarily mean that full amount of the insurance coverage will be available if a claim arises. This is because prior claims could have depleted some or all of the coverage funds. Even if the consultant agrees to use its insurance limits as the LOL, the contract should provide that unavailability of the full insurance coverage will not affect any rights the client may have to pursue its rights under the agreement.

Some consultants also try to impose a time limitation on the client's right to bring a claim. It is true that the EPA AAI Rule and ASTM E1527 allow prospective purchasers to use reports prepared up to 180 days prior to the date of acquisition of the property. Reports older than six months may be used provided that certain AAI components are updated. These components are: (i) interviews with past and present owners, operators, and occupants; (ii) searches for recorded environmental cleanup liens; (iii) reviews of federal, tribal, state, and local government records; (iv) visual inspections of the facility and of adjoining properties; and (v) The declaration by the environmental professional.

This so-called "shelf life" should not be confused with the statute of limitations for a negligence or breach of contract action. Some consultant forms attempt to shorten the period for asserting claims to one year or provide that the report may not be used or relied upon after six months. Clients should not agree to a shorter period than the applicable statute of limitations for bringing a professional negligence or breach of contract claim.

The standard terms and conditions will also provide that the consultant will not be liable for consequential damages flowing from any negligence or breach of contract. If the client can obtain concessions on the other issues discussed, this provision can be acceptable.

Indemnity

Consulting agreements frequently request that the client indemnify the consultant for any injuries or losses resulting from site conditions. If the client is a lender or other party who is not in control of the site, the client should not agree to such a provision.

Reliance

The question of who is entitled to rely on ESAs has proved to be a hotly contested issue in due diligence litigation. In the absence of any limitation in the agreement, many courts may use a "reasonably foreseeable" test to determine to which parties that consultant may owe a duty. For example, if a lender orders a Phase 1 to finance the acquisition of a property, the purchaser/borrower might try to argue that it was foreseeable that it would rely on the report so that it should be able to seek damages from a consultant who might have failed to identify a REC. As a result, the standard terms and condition will usually specify the parties who may be able to rely on the ESA and create a time limitation on how long those parties can rely on the Phase 1 ESA. Courts have generally upheld such reliance provisions.

Some consultants will provide a reliance letter to additional parties for a fee. Consultants who regularly work with lenders will often agree to broader reliance language, especially when the loan is to be securitized without an additional charge.

Miscellaneous Documentation And Reporting Issues

The standard terms and conditions typically provide that all reports and documents generated during the performance of the work are the property of the consultant. This can be problematic for clients who are concerned about confidentiality and inadvertent disclosure of information developed during the investigation. Thus, property owners should insist that all materials, including drafts, drawings, photographs, and field notes, are the property of the client and that the consultant will not release any information obtained in the investigation to any third party without the express written consent of the client. Furthermore, the consultant should agree to destroy any draft reports and field notes at the conclusion of the project. It is advisable that the first written report be marked as a draft report so the client can make changes to the report without having to incur additional fees or charges.

Clients are also often asked to be responsible for obtaining permits or to be responsible for disposal

of any hazardous residues generated from laboratory analysis. The consultant should be responsible for obtaining permits, complying with the conditions of such permits, and disposing of any sampling residues. However, the client should be willing to sign the manifests as the generator of the waste.

Information To Be Provided By Client

Under AAI, the person seeking the benefit of the CERCLA landowner defenses has the responsibility for the providing the following information:

- Cleanup liens;
- Specialized knowledge or experience of the person;
- Relationship of purchase price to fair market value if uncontaminated; and,
- Commonly known or ascertainable information.

As a result, consultants will often provide a questionnaire to the client to complete. However, the client does not actually have to provide this additional information to the environmental professional. Indeed, when the client is the lender, they will tend not to have this information. If the client does not provide the information, the environmental consultant has to determine if the information not furnished by the person may affect the ability of the consultant to render an opinion about the potential for conditions at the property that are indicative of a release. If so, the consultant could identify this as a "data gap" and then comment on the significance of this data gap.

A related area of confusion for consultants has been whether the environmental professional needs to review the chain of title. The AAI rule does not require the environmental professional to obtain a chain of title. Instead, the rule provides that the environmental professional should exercise its professional judgment in determining what types of historical may provide useful information. One of the reasons for reviewing chains of titles is to obtain information about land use controls. The chain of title can be a problem for an environmental consultant because it is usually not ordered until the transaction is about to close and after the Phase 1 had been ordered and completed. In addition, chain of title often can cost $300 or more per parcel and can take several weeks to obtain, depending on the county where the records are retained. In addition, multiple chains of titles might have to be ordered if the property had been subdivided in the past or was part of a larger tract of land.

There may be other sources of information that the environmental professional is required to review that could yield the information required to satisfy AAI or ASTM E1527-05. Thus, the client and environmental professional should clarify if and who will be ordering chain of title reports.

Warranties

The typical standard terms and conditions will provide that the consultant is not warranting the accuracy, completeness, or validity of information provided by third parties. In other words, the consultants will discuss the information contained in database reports but not guarantee that the information is accurate. ASTM generally requires that if an environmental consultant uses a third party database company to provide historic regulatory database as opposed to obtaining the information directly from the regulatory agency, the database must updated at least every 90 days to be considered current. To minimize the risk that third party database is inaccurate, the user should verify that environmental consultant has used current information.

Payment

Many consulting agreements provide for accrual of interest after 30 days. If the client is a large corporation that cannot generate payments rapidly, it is advisable to request a longer accrual period of 60 to 90 days.

Termination

The client should also seek the right to terminate the contract for any reason and have the consultant agree not to incur any further charges upon receipt of the termination notice. Many agreements normally provide that the consultant may finish the particular Phase of the work following receipt of the termination notice.

Findings And Opinions

ASTM E1527-05 provides that the Phase 1 report have a "Findings" section that identifies known and suspected environmental conditions associated with the property, including REC, historical recognized environmental condition ("HREC"), and de minimis conditions. In addition, the environmental professional should discuss in a separate "Opinion" section the logic and reasoning used in evaluating the effects of the known or suspect environmental conditions on the property. The opinion section must include the specific rationale for concluding that a known or suspect environmental condition such as a HREC is not currently a REC. Known or suspected environmental conditions that are identified as an REC must also be listed in the conclusions section.

Conclusions And Recommendations

ASTM E1527-05 also requires that reports must contain a conclusion that summarizes all RECs identified at the property and the effects of the RECs on the property. However, an environmental consultant is NOT required to provide a recommendation about RECs. Instead, ASTM E1527 provides that an opinion requiring additional investigation should only be provided "in the unusual circumstance" when the environmental professional is unable to determine if there is a REC or when greater certainty is required an identified REC. Under this strict reading, once an environmental professional is able to identify a REC, no further investigation is required for purpose of satisfying the AAI requirement. In other words, once a consultant documents that there is contamination from a leaking underground storage tank, ASTM E1527 does not require the consultant to provide an opinion whether further investigation is appropriate.

A property owner should carefully consider if it wants a consultant to provide recommendations in a report. If a report contains recommendations and the client fails to implement the recommendations, this failure could be used as evidence that the client did not comply with its post-acquisition "continuing obligations" that are necessary to maintain its liability protection. If a Phase 1 identifies RECs that require additional investigation, the better practice would be to have the environmental consultant provide recommendations in a side letter addressed to counsel.