By Larry Schnapf

How Phase 1 Reports Can Hurt Your Clients

Purchasers of property and their lenders perform Phase 1 environmental site assessments to identify environmental issues associated with the real estate and to qualify for one of the liability protections available under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA or Superfund), 42 U.S.C. §9601 et seq. However, ill-conceived Phase 1 reports can actually cause parties to lose their liability protection or expose them to misrepresentation claims. This article will discuss several cases that illustrate this danger.

CERCLA Liability Concerns For Property Owners Or Occupiers

CERCLA imposes strict liability on four categories of responsible parties including current owners or operators of property for the cleanup of releases of hazardous substances even if the contamination occurred prior to the time the owner acquired title or the operator came into possession of the property. 42 U.S.C. §9607(a)(1). Past owners or operators may also be liable if they owned or occupied the property at the time of disposal of the hazardous substances. 42 U.S.C. §9607(a)(2).

CERCLA does have a number of affirmative defenses for property owners or operators including:

- The third-party defense, 42 U.S.C. §9607(b)(3);
- The innocent landowner (ILO) defense, 42 U.S.C. §9601(35)(A);
- The bona fide prospective purchaser (BFPP) defense, 42 U.S.C. §9601(40); and
- The contiguous property owner (CPO) defense, 42 U.S.C. §9607(q).

To satisfy the third-party defense, an owner or operator would have to demonstrate by a preponderance of the evidence that: the release was solely caused by a third party; whom the defendant did not have a direct or indirect contractual relationship; the defendant exercised due care with respect to the con-

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tamination; and took steps against foreseeable acts or omissions of third parties. To qualify for the ILO, BFPP and CPO liability protections, a property owner or operator must, among other things, demonstrate that it investigated the past use and ownership of the property consistent with the requirements of the EPA "All Appropriate Inquiries" (AAI) rule and complied with a series of post-acquisition obligations including exercising "appropriate care" with respect to contamination at the property. 40 C.F.R. pt. 312. See my article, *The New "All Appropriate Inquiries" Rule,* which appeared in the January 2007 issue of The Practical Real Estate Lawyer.

Environmental Risks Not Limited to Recognized Environmental Conditions (RECs)

Phase 1 reports were initially developed to determine if a there has been a release of hazardous substances at a property and to enable property owners to qualify for one of the CERCLA landowner liability defenses. To satisfy the CERCLA landowner liability protections, a Phase 1 must either satisfy the requirements of the EPA AAI rule or the ASTM E1527 Standard Practice for Environmental Site Assessments. A report following the ASTM protocol will use the term "recognized environmental condition" (REC) to indicate if there is or may be a release of hazardous substances at the property. The ASTM E1527 Standard Practice for Phase 1 Environmental Site Assessments 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 release of any hazardous substances or petroleum products into structures on the property or into the ground, groundwater or surface water of the property." Because this term involves a certain level of professional judgment, it is not unusual for a property owner or its counsel to disagree with an environmental consultant if a certain condition rises to the level of a REC.

Over the year, though, the use of Phase 1 reports have evolved so that they frequently include environmental issues (e.g., asbestos, lead-based paint, radon, mold) that do not fall within the definition of a REC because they do not involve releases of hazardous substances but could still be a concern to a property owner, tenant or lender. In the ASTM terminology, these additional environmental issues are called non-scope items or business environmental risks (BERs).

The presence of these conditions would not be identified as a REC because they do not involve releases of hazardous substances as defined under CERCLA. Depending on the preferences of the person ordering the report, these non-RECs may be identified in the Phase 1 report as a separate category. The fact that an issue is not identified as a REC does not mean that there is no potential environmental liability associated with the property but just that there are no releases of hazardous substances that could lead to CERCLA liability. Unfortunately, many real estate owners, investors and even courts are not aware of this distinction.

An example of how sophisticated parties may not understand the significance of non-REC issues was the decision in *Bank of New York Mellon Trust Company et al v. Morgan Stanley Mortgage Capital Inc. (MSMCI),* 2011 U.S. Dist. LEXIS 69168 (S.D.N.Y. June 27, 2011), in which the federal district court for the Southern District of New York denied a motion to dismiss filed by a mortgage originator who was alleged to have failed to adequately disclose environmental conditions at a shopping center.

In this case, the defendant originated an $81 million loan to finance the acquisition of a shopping center in December 2006. MSMCI sold the loan in May 2007 to an affiliated entity pursuant to a mortgage loan purchase agreement (MLPA). The loan was then deposited into a Morgan Stanley CMBS Trust pursuant to a pooling and servicing agreement (PSA) with the plaintiff named as Trustee. The MLPA contained an environmental warranty that an environmental assessment had been performed and that MSMCI had no knowledge of any material and adverse environmental conditions or circumstances affecting the property that was not disclosed in the report. MSMCI also warranted that there were no material defaults.

The shopping center had been constructed on a former landfill, was required to monitor methane gas and had been subject to a number of violations. Just before the loan closed, the largest tenant of the shopping center issued a Notice of Default accusing the owner of failing to properly manage the methane gas and alleging that methane gas levels had reached dangerous levels. The property owner and the anchor tenant then entered into a series of letter agreements whereby the owner agreed to address the methane problem. The borrower then purchased the property and assumed the obligations. Unfortunately the methane problems persisted and the anchor tenant eventually terminated its lease, causing the borrower to default on its debt service payments.

The lender's pre-acquisition Phase 1 had not identified any RECs since methane is not a CERCLA hazardous substance. However, the report identified methane as an "item of environmental concern." It also disclosed that the shopping center had been constructed on a landfill, that it was required to monitor methane and that there had been violations that would require at least $100,000 to repair. The Phase 1 was included in the loan documents provided to the CMBS trust.

After the borrower defaulted, the plaintiff through the special servicer filed a complaint seeking to require MSMCI to re-purchase the loan. The complaint alleged that MSMCI knew and failed to disclose that the borrower was in default of its lease at the time of MPLA, and also failed to disclose the adverse environmental conditions affecting the property. In its motion to dismiss, MSMCI asserted that it had disclosed the environmental risks associated with the property including that the property had been built on a landfill, required monitoring for methane, was under the supervision of the Ohio EPA and an escrow of approximately $150,000 had been established to resolve outstanding environmental violations.

Despite the fact that the Phase 1 discussed the methane issue, the court declined to grant the defendant's motion to dismiss. Perhaps exhibiting a lack of familiarity with how Phase 1 reports are used in financing transactions, the court said the purpose was to identify RECs, that the report had not identified any RECs and that an "item of environmental concern" was not congruent with a REC. As a result, the court said there was a material dispute if the Phase 1 had adequately disclosed the existence of a material environmental threat.

What About Those Recommendations?

In *Ashley II Charleston LLC v. PCS Nitrogen,* 746 F. Supp. 2d 692 (D.S.C. 2010), an entity owned by the brownfield developer Cherokee failed to qualify for the BFPP when it failed to timely address environmental issues that had been identified in a Phase 1 report.

In this case, the plaintiff purchased a former fertilizer plant that it planned to develop into a mixed-use development. Ashley performed a pre-acquisition Phase 1 that identified a number of RECs associated with the historic operations at the Site. In particular, the Phase 1 disclosed a sump in an exterior wash bay was clogged with silt and contaminated residue, noted that the berm around the pad would not prevent contaminated wash water from flowing off the pad and into the soil, and observed significant staining and cracks in a concrete slab that increased the potential for a release to migrate to the subsurface. The report recommended, inter alia, cleaning out the sumps, sampling beneath the slabs to determine if there were any impacts to the environment, investigating and removing the debris pile and maintaining the limestone cover on the site.

After acquiring title, Ashley filed a cost recovery action against PCS Nitrogen as successor to the company that operated the fertilizer plant for approximately $190,000 in past costs and for a finding of liability for the estimated $8 million in future remediation costs. PCS, in turn, filed a counterclaim against Ashley, alleging it was partially responsible as the current owner of the property for the cleanup. Ashley claimed it qualified as a Bona Fide Prospective Purchaser (BFPP) under CERCLA and therefore had no liability for the contamination.

To qualify for the BFPP defense, a party must, among other things, perform a pre-acquisition investigation that satisfies EPA's AAI rule and comply with certain obligations after taking title including exercising "appropriate care" with respect to known contamination. After a trial, the federal District Court for the District of South Carolina ruled that Ashley had failed to comply with its post-acquisition "appropriate care" obligations because it had failed to timely implement the recommendations contained in the Phase 1 report. The court noted that after Ashley demolished the structures, it waited a year to test, clean out and fill in the sumps. The court said that this allowed the cracked sumps to become filled with rainwater, possibly exacerbating site conditions. The court also noted that Ashley failed to maintain the crushed rock surfacing, allowing contaminated runoff to spread contaminants. Finally, the court observed that Ashley did not adequately conduct sampling from beneath the slabs to assess potential impacts to soil and groundwater.

This decision illustrates the dangers of having recommendations in Phase 1 reports. An environmental consultant is not required to provide a recommendation in a Phase 1 report but simply to provide an opinion and conclusion about the presence or potential presence of a REC. If a client wants a recommendation about what to do about any RECs that are identified, it should be prepared to timely implement the recommendation or risk losing its BFPP protection. The better approach would be to have all recommendations (including those involving any non-scope items addressed by the report) contained in a separate letter addressed to counsel.

Can A Borrower Rely On The Lender Acceptance A Phase 1 Report?

Lenders have long played a role as "surrogate regulator" in transactions. In many cases, lenders force potential borrowers to investigate suspected contamination and frequently require remediation under state oversight. Borrowers often balk at these requests and may even retain their own independent consultants to try to convince lenders that the work is not required or necessary.

However, borrowers usually do not exhibit such independence when the lenders are comfortable with the site conditions. Borrowers typically believe that a site is "clean" if a bank determines that a Phase 1 is acceptable. However, what many borrowers do not realize is that lenders are positioned differently than property owners from a liability standpoint and therefore may have risk tolerances that are different from those who take title to potentially contaminated property.

Because of the secured creditor exemption under CERCLA and most state superfund laws, lenders will not be liable for remediation unless the borrower encounters financial difficulties and the bank either takes over the borrower's operations or forecloses on the property. As a result, the bank's liability for environmental conditions is generally limited to the value of the loan. When banks held loans on their balance sheets, this potential loss was often enough to incentivize lenders to perform thorough Phase 1 reports. However, in this era of securitization, originating lenders may not be as concerned about the long-term environmental risks associated with a property. So long as the loan has been originated in accordance with the loan procedures and underwriting that is acceptable to the trusts that sell the CMBS loans to investors, the risk of a "comeback" to the originating lender is minimal.

However, as the property owner, the borrower will be first in line for any enforcement actions that may result if the land turns out to be contaminated. Indeed, there have been a number of recent cases where borrowers relied on a Phase 1 that was acceptable to its lender only to find out after the borrower acquired title that the site was contaminated. *See Ridge Seneca Plaza v BP Products, et al,* 2011 U.S. Dist. LEXIS 47288 (W.D.N.Y. May 2, 2011); *Ironwood Homes v Bowen,* 2010 U.S. 58750 (D. Or. June 14, 2010); *Robert Hull and Point Pleasant Landco v. William Lewis* 2009 N.J. Super. Unpub. LEXIS 1412 (N.J. Super. Ct. App. Div. June 11, 2009). These cases illustrate the importance of a borrower independently evaluating the environmental conditions of its property even if this means reviewing the Phase 1 performed on behalf of the bank.