# SCHNAPF ENVIRONMENTAL JOURNAL

**A Newsletter Covering Recent Environmental Developments and Caselaw**

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*The Schnapf Environmental Journal is a bi-monthly report that provides updates on regulatory developments and highlights significant federal and state environmental law decisions affecting corporate and real estate transactions, and brownfield redevelopment. The information contained in this newsletter is not offered for the purposes of providing legal advice or establishing a client/attorney relationship. Environmental issues are highly complex and fact-specific and you should consult an environmental attorney for assistance with your environmental issues.*

# DUE DILIGENCE

### *Federal Court Allows Claims To Proceed Against Consultant*

A federal district court allowed a developer to proceed with a claim for negligent misrepresentation and negligence against a consultant for failing to discover the presence of thorium contamination in an area of Chicago known to have thorium-contaminated fill materials.

In *Grand Pier Center LLC v. ATC Group Services, Inc.*, 2008 U.S. Dist. LEXIS 94255 (N.D. Ill 11/14/08), the R.M. Chin and Associates, Inc. (RMC), the managing member of the plaintiff, retained ATC Group Services in August 1997 to perform a Phase I environmental site assessment (ESA). Grand Pier had planned to develop the property into a hotel, condominiums and retail store complex. The development parcel was located in the Streeterville area of Chicago between two former gaslight mantle manufacturing sites that had been operated by Lindsay Light Company in the early 20th century. Lindsay Light had extracted thorium from imported monazite sand using an acid stripping process. The thorium extraction process produced radioactive waste known as mill tailings. Lindsay Light disposed the mill tailings at its two facilities and the radioactive waste has been found at 10 other sites in the Streeterville area.

The ATC Phase I ESA report indicated that the neighboring property called the “Lindsay Light II” had been identified in the Comprehensive Environmental Response, Compensation and Liability Information System (CERCLIS) database ,but that EPA had completed a removal action in 1996. Nevertheless, ATC recommended soil and groundwater investigation.

ATC performed a Phase II investigation in September 1997 to assess the impact of prior uses on the soil and groundwater. The Phase II report discussed the presence of volatile and semi-organic volatile organic compounds and indicated that they did not pose an environmental or health threat. ATC provided Grand Pier LLC with the right to rely on the Phase I and 2 reports. In October 1997, Grand Pier LLC purchased the property.

In April 1999, ATC issued an updated Phase I ESA report to RMC but did not provide reliance to Grand Pier. The 1999 Phase I ESA disclosed that a gaslight mantle manufacturer that used radioactive thorium had formerly occupied the neighboring Lindsay Light II site, that elevated levels of thorium had been found in the Lindsay Light II area, and that removal actions had been performed in 1994 and 1996. The report concluded that because regulatory agencies were monitoring the Lindsay Light II site, it posed a low potential environmental risk and no further investigation was warranted.

In February 2000, the plaintiff discovered the property was contaminated with thorium at levels that posed an imminent and substantial endangerment. Thorium was measured at 244 times the EPA cleanup level. At the highest concentrations found, a person would have been exposed to the maximum recommended annual exposure in just 20 minutes. Grand Pier was ordered by EPA to halt excavation for the project and removed over 10,000 tons of radioactive soil. Contending that the time and money it expended caused the project to fail, Grand Pier filed a lawsuit against ATC claiming that ATC failed to investigate and disclose radioactive thorium contamination.

ATC filed a motion for summary judgment for the negligent misrepresentation and negligence counts of the complaint. The federal district court for the northern district of Illinois concluded that the statement in the Phase I ESA that the contamination at the Lindsay Light site had been remediated was false. The court said that ATC was hired to assess the property's environmental condition and that the existence of a completed remediation was a material fact.

ATC argued it had relied on information provided by a third party. However, the court found it significant that one of the ATC employees had reported to the project manager for the investigation that he had been concerned about radiation issues in that area within days of the ATC Phase I ESA report but ATC had failed to revise its Phase I ESA report. The court also noted that the purpose of the Phase II ESA was to evaluate subsurface conditions to assess impacts from prior uses yet ATC never sampled for radioactive waste and also failed to include information about radiation in its Phase II ESA report, thereby ignoring the stated purpose of the Phase II ESA. At the trial, there was conflicting testimony whether the concerns about radioactive materials was discussed with RMC; however, the court found credible the testimony of Raymond Chin that he would have requested additional investigation had he known the remediation was not completed. The court concluded there was a genuine issue of material fact whether ATC had negligently misrepresented the environmental conditions at the Grand Pier site in the Phase I report and that ATC misrepresented its investigation of the impact of the Lindsay Light 2 site on the development parcel. On the negligence count, the court also held that there were genuine issues of material fact as to whether ATC falsely stated or omitted material facts in the Phase I ESA and Phase II ESA reports.

With respect to the revised 1999 Phase I ESA, the court found that Grand Pier never obtained the right to rely on that report. As a result, Grand Pier could not have reasonably relied on the updated 1999 Phase I ESA reports or been a foreseeable user. Thus, the court granted ATC's motion for summary judgment on the negligent misrepresentation and negligence counts for the revised 1999 Phase I ESA

***Commentary:*** *In a related action, Grand Pier was allowed to maintain* *a number of claims against the successors of Lindsay Light in Grand Pier Center LLC and American International Specialty Lines Insurance Co. v. Tronox, LLC et al., 2008 U.S. Dist. LEXIS 88201 (N.D. Ill. 10/31/08).*

## *Bankruptcy Motion Illustrates Environmental Issues Associated with Partially-Constructed Developments*

As the credit crunch forces developers to abandon construction projects, lenders are confronted with decisions whether to foreclose on properties in various stages of construction or try to sell the loans to potential purchasers. Lenders and purchasers are increasingly conducting new environmental site assessments and not relying on the Phase I ESAreports that were done when the loans were first originated or land initially purchased.

However, is the standard ASTM Phase I ESA report adequate for evaluating environmental issues associated with these incomplete projects? A motion that was recently filed in the Lehman Brothers bankruptcy case highlights some of the environmental compliance issues that lenders and prospective purchasers should consider evaluating in their environmental due diligence where developments have been halted.

In the motion, the SunCal Companies and affiliated entities alleged that Lehman Brothers had defaulted on a $2.3 billion construction loan for a variety of residential development projects throughout the country by failing to fund on-going critical expenses of the projects. Among the environmental issues identified by the SunCal affiliates that required funding were stormwater control measures to prevent soil erosion during wet weather and to comply with various permit conditions, dust control measures that were leading to violations of air quality standards and to abatement of friable asbestos at partially-demolished structures to prevent windblown asbestos fibers. The projects not only needed funds to complete this work but also potentially faced significant fines for failing to comply with permit conditions.

In addition to managing stormwater runoff, airborne dust and asbestos, construction projects frequently have wetland mitigation obligations, endangered species conservation plans and disposal of hazardous and solid wastes generated by the project. At some development projects, the permits and other environmental entitlements might be approaching their expiration dates. For example, EPA recently fined a construction project $106K for failure to immediately clean up dirt tracked out 50 feet beyond the site, and failure to water down disturbed surface areas while conducting earth moving operations. As part of the settlement, all current and new employees of the developer involved in dust-generating activities were required to complete dust-control training, the company was required to certify every six months that training was up-to-date, and has to employ a qualified dust control coordinator at all Maricopa County sites equaling or exceeding 5 acres in disturbed surface area.

***Commentary:*** *Recently, the California Department of Toxic Substances (DTSC) recently issued a press release in response tothe state's unprecedented numbers of foreclosed homes and the abandoned household hazardous materials they often contain. DTSC reminded lenders that when they foreclose on properties and contract with restoration companies to prepare them for resale that they may be liable for appropriately handling the materials and hazardous waste left behind. The agency said that vacant homes frequently contain hazardous materials including pesticides, paint, batteries, cleaning solvents and many other items that may be hazardous once they are determined to be wastes. The DTSC said that disposing hazardous waste in the trash or a municipal dump, pouring it down the drain, or otherwise mishandling the materials could expose lenders to fines of up to $25,000 per day, per incident.*

*To avoid these consequences, DTSC recommended a number of options to lenders and restoration companies. The first option was identifying companies who could use the materials for their intended purposes so that they do not become wastes at all. Another option is to work with local Certified Unified Program Agencies and DTSC to become a "Conditionally Exempt Small Quantity Generator," which allows self-transportation of small amounts of hazardous waste to a permitted hazardous waste facility.*

## *EPA Revises Audit Policy*

On August 1, 2008, EPA published its "*Interim Approach to Applying the Audit Policy to New Owners*" ("Interim Policy") to encourage owners of businesses to audit and correct environmental violations at recently-acquired regulated facilities (73 FR 44901).

Under its ''Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations'' ('Audit Policy') published in 2000 (65 FR 19618, April 11, 2000), EPA offers reduced penalties to companies that self-audit their facilities, promptly disclose and correct any violations discovered, and take steps to prevent future violations. Under the interim policy, an owner who acquires a new facility may receive additional penalty reductions from disclosing an even greater range of violations. The incentives tailored for new owners include clearly defined penalty mitigation beyond what is offered by the Audit Policy, as well as the modification of certain Audit Policy conditions that will allow more violations to be eligible for the Policy.

On May 14, 2007, EPA published a notice that it was seeking public comment on the idea of offering tailored incentives to new owners, ''Enhancing Environmental Outcomes: From Audit Policy Disclosures Through Tailored Incentives for New Owners'' (72 FR 27116). The agency received comments that supported the approach to implement the policy on an interim basis.

Under the Interim Policy, an eligible new owner must certify that prior to the transaction it was not responsible for environmental compliance at the facility that is the subject of the disclosure, did not cause the violations being disclosed and could not have prevented the occurrence, the violation that is the subject of the disclosure originated with the prior owner, neither the buyer nor the seller held the largest ownership share of the other entity prior to the transaction, and the buyer and seller did not have a common corporate parent.

Eligible new owners would be entitled to penalty mitigation if they disclose violations to EPA, or enter into an audit agreement with EPA within 9 months of the transaction closing, and meet all the Conditions of the Audit Policy, as modified for new owners. Under the Interim Policy, EPA will not assess against the new owner for the period before the date of acquisition. Penalties for economic benefit associated with avoided operation and maintenance costs will be assessed against the new owner but only from the date of acquisition. EPA will not assess penalties for economic benefit associated with delayed capital expenditures or with unfair competitive advantage if the new owner corrects the violations within 60 days of discovery or another reasonable timeframe to which EPA has agreed.

Following is a description of the modifications EPA has made to its Audit Policy for new owners. Except for the changes discussed below, EPA will apply and interpret all other Conditions of its 2000 Audit Policy, the 2007 Frequently Asked Questions document and its 1997 Audit Policy Interpretive Guidance.

**Systematic Discovery (Condition 1) -** Since EPA recognizes that a new owner's pre-closing due diligence is by its nature a one-time event, EPA will waive the "periodic" element of this condition for violations discovered through pre-acquisition due diligence, and allow such disclosures to be considered for full penalty mitigation.

**Voluntary Discovery (Condition 2) -** EPA will expand its interpretation of the Voluntary Discovery condition in the new owner context which is currently limited to compliance with Title V of the Clean Air Act to allow consideration of all violations which would otherwise be ineligible for Audit policy consideration because they are already required to be identified through a legally mandated monitoring, sampling or auditing protocol, and thus not "voluntarily discovered." New owners that enter into an audit agreement or disclose violations before the first instance when the monitoring, sampling or auditing is required would not be disqualified based on this condition.

**Prompt Disclosure (Condition 3) -** For violations discovered pre-closing, a new owner would have up to 45 days after closing to disclose violations. For violations discovered post-closing, a new owner would have to disclose violations within 21 days after discovery or within 45 days after the transaction closing, whichever time period is longer.

**Other Violations Excluded (Condition 8)-** Where violations that gave rise to serious actual harm or an imminent and substantial endangerment began before the new owner acquired the facility, EPA will allow such violations to be eligible under the Interim Approach, absent a fatality, community evacuation or other seriously injurious or catastrophic event. This should encourage new owners to come forward and correct significant violations, which is one of the goals of this approach.

**Cooperation Condition (Condition 9)-** EPA is modifying the Cooperation condition of the Audit Policy only to make clear that the disclosing entity must cooperate with EPA in determining whether all Audit Policy conditions - as they have been modified by this Interim Approach - have been met.

# CONTAMINATED PROPERTIES/BROWNFIELDS

## *Seventh Circuit Vacates Decision Holding Tax Deed Purchaser Liable as CERCLA Owner*

In the wake of the credit crisis, an increasingly popular strategy used by real estate investors is to purchase deeply discounted loans or acquire rights to contaminated properties at distressed prices, properties through foreclosure or tax sales without actually taking title to the land. The successful bidders then either bring an action under section 7002 of the Resource Conservation and Recovery Act (RCRA) to compel responsible parties to remediate the site and sell the tax certificate or note at a profit or wait for brownfield developers to purchase the property.

In our May/June 2007, we reported on *United States v. Capital Tax Corporation*, 2007 U.S. Dist. LEXIS 1184 (N.D. Ill. 1/4/07), which highlighted some of the risks associated with this strategy. In that case, the federal district court ruled that the tax certificate purchaser was not entitled to the CERCLA secured creditor exemption and was therefore liable as a CERCLA owner for the cleanup of all of the parcels comprising the site. (Readers interested in a full discussion of the relevant facts of this case should consult the May/June SEJ issue.) The United States Court of Appeals for the Seventh Circuit recently vacated and remanded this case *U.S. v. Capital Tax Corporation*, 2008 U.S. App. LEXIS 20056 (7th Cir. 09/19/08)

In rejecting the argument that the defendant held legal title to secure a security interest, the district court said that the defendant could not be a lender since it had never loaned or lent money to any party. On appeal, though, the United States ruled that the CERCLA secured creditor exemption was not limited to "typical" lending scenarios and that a land sale contract could qualify as a security interest under the doctrine of equitable conversion. The court said that under Illinois law, a land sale contract will transfer equitable title to a purchaser but the seller will retain legal title in trust as security for the payment of the purchase price.

For the doctrine of equitable conversion to apply, there must be a valid and enforceable contract. Since the land sale contract was oral, the appeals court ruled that Capital Tax had to satisfy the partial performance exception to the Statute of Frauds. To take a contract outside the Statute of Fraud, the appeals court said Capital Tax was required under Illinois law to show that the buyer had made partial or whole payment, had taken possession, and had made substantial and leasing improvements to the property. While Capital Tax had presented some evidence to show part performance, the appeals court said that the district court had not evaluated the evidence since the lower court had found there was no security interest. Accordingly, the appeals court remanded the matter to determine if there was an enforceable contract. The court did observe that if there was not a valid contract, the defendant would be liable as an owner under CERCLA. If there was a valid contract and if the district court found that equitable conversion applied, the appeals court said Capital Tax would not be liable as a CERCLA owner by virtue of the secured creditor exemption.

The district court had also found Capital Tax jointly liable for the cleanup of the entire site even though it had held title to only 5 of the 7 parcels. The appeals court said there was undisputed evidence that the products and chemicals continued to migrate between parcels after operations at the facility had ceased. The court also noted that containers were deteriorating and leaking, and that contaminated runoff from paint and other chemicals mixing with rain water from the leaking roof had flowed to other parts of the building and onto the streets. Further, the court said it was undisputed that individuals were moving containers from parcel to parcel, spilling paint and other substances in the process. Thus, the appeals court said it is immaterial whether Capital Tax actually moved any of these containers because it failed to secure the premises from third parties and, in general, turned a blind eye to the property. Due to the commingling, cross-contamination and migration occurring on a site that formerly operated as a single, unitary operation, the court held there was no basis for apportionment.

## *Michigan Appeals Court Rules Lender Not Liable as Operator By Implementing Cleanup*

In our October 2006 issue, we reported on an unpublished decision of the Michigan Court of Appeals in *Hicks Family Limited Partnership v. 1st National Bank of Howell* where the court dismissed various common law claims but reversed the dismissal of a cost recovery action against the bank under the state superfund law known as Natural Resources and Environmental Protection Act (NREPA). The court remanded the matter back to the trial court to determine if the lender could be liable as an operator or generator under NREPA. The trial court subsequently determined that since the plaintiff was a PRP it could not maintain a cost-recovery action under NREPA and even if it could, there was insufficient evidence to establish that the bank was an operator or generator (Readers should read the October 2006 issue for more detailed discussion on the relevant facts involved in this case).

Once again, the plaintiff appealed and the Court of Appeals affirmed (2008 Mich. App. LEXIS 1444, 7/15/08). The Court of Appeals agreed that the plaintiff’s status as a PRP did not preclude it from bring a cost recovery action under section 201 of NREPA. The appeals court said that case law interpreting the federal Comprehensive Environmental Response, Liability and Compensation Act (CERCLA) was instructive for NREPA litigation since NREPA had been modeled after CERCLA. The court noted that at the time the trial court ruled on the plaintiff's motion, there had been a split of authority in the federal circuits on whether a PRP could bring a cost recovery action under CERCLA. However, the appeals court said that the United States Supreme Court resolved the dispute in *United States v. Atlantic Research Corp*.,127 S. Ct. 2331, 168 L. Ed. 2d 28 (2007). Accordingly, the appeals court ruled that the trial court erred when it granted the bank's motion for summary judgment based on the plaintiff's status as a PRP.

The appeals court agreed with the trial court that the defendant bank was not an 'operator' or 'generator' at the site. The plaintiff had introduced evidence that a contractor hired by defendant ruptured a barrel during the cleanup operations in 1984 and the court ruled that this was sufficient to show that defendant disposed of a hazardous substance and was responsible for an activity causing a release. However, the appeals court held that the plaintiff had to show that the defendant must have had authority to control the operations or decisions involving the disposal of the hazardous substance, or must have assumed responsibility or control over the disposition of the hazardous substance. Since the defendant's only connection to the site was its remedial clean-up effort, the court said this was insufficient to establish the requisite nexus required for liability as an operator. Further, the court ruled that defendant could not be held liable as an arranger as it did not intend the 1984 disposal.

***Commentary:*** *Perhaps the bank did not comply with the foreclosure rules set forth in the state secured exemption or felt it did not act retroactively. In any event, the bank was forced to defend itself as a former landowner of the property without the extra layer of protection that is provided by the expansive state secured creditor defense.*

*Lenders encounter their greatest risk of liability during post-foreclosure activities, and the HSBC case highlights the importance of a lender exercising extreme caution when winding down operations at a borrower's manufacturing facilities. Under the 1996 Asset Conservation, Lender Liability Deposit Insurance Act, also known as the Lender Liability Amendments, a lender may maintain business operations, wind down operations, take measures to preserve, protect and prepare the vessel or facility for sale or disposition, and even undertake response actions under section 107(d) (l) of CERCLA so long as the lender seeks to sell or re-lease (in the case of a sale/leaseback transaction) and complies with certain foreclosure requirements. Banks continue to find themselves subject to environmental issues because of actions they took during workouts or following foreclosures. Many of these enforcement actions involve administrative orders or lawsuits that are quietly settled by governmental agencies. These situations have typically taken place when a borrower has gone out of business and the bank takes control of the facility in order to sell off the inventory, fixtures, machinery and equipment of the borrower subject to* *the bank's lien. The bank typically does not take title to the property because of fear that it will lose its exemption, but instead hires an auction house to conduct the sale of the property. Usually, there are barrels or drums of hazardous waste strewn about the facility and the equipment that is being auctioned off may even contain hazardous wastes. To avoid any suggestion that the bank or the auction had any control over hazardous wastes, the auction will often rope off the area where the drums or barrels are found. After the auction is conducted, the drums and barrels are then left in the abandoned facility. At some point, government authorities discover that there are abandoned drums at the facility and order the lender to pay for the removal of the materials. Lenders should be aware that the definition of 'release' under CERCLA includes abandonment of drums. Thus, a lender who has taken control of a facility to conduct an auction and leaves behind drums or equipment containing hazardous wastes could be deemed to have caused a threatened release of hazardous substances. EPA has consistently taken the position that such action constitutes abandonment of hazardous wastes (when the borrower is insolvent) and creates generator liability for the lender. As a result, financial institutions should consult with environmental counsel prior to taking possession of a former borrower's facility or conducting any auction at a manufacturing facility. It would also be advisable for lenders to retain an environmental consultant or environmental attorney to inspect the facility prior to taking control in order to evaluate the possible environmental liabilities that might be associated with the auction. The financial institution could have its environmental consultant or attorney perform a regulatory review of the facility to minimize the possibility that the lender could incur liability for releases of hazardous substances at that treatment or disposal facility.*

## *No Further Action Letter Needed to Pursue Contribution*

An Ohio state court ruled that a property owner seeking contribution under Ohio's Voluntary Action Program first must obtain a "no further action letter" from a certified professional.

In *Paxton v. Wal-Mart Stores Inc.*, 2008 Ohio App. LEXIS 2094 (Ct. App- 6th Dist., 5/23/08), Wal-Mart had entered into a contractual arrangement with a recycling company, Enviro Inc., that operated on Paxton's property. The recycler was supposed to recycle or otherwise dispose of various Wal-Mart products, including fluorescent and HID bulbs and lamps with mercury as well as mini-blinds containing lead. The contract provided that the risk of loss and responsibility for proper disposal would pass to Enviro when it obtained possession of the lamps. Instead of processing the products at the recycling facility, Enviro crushed or shredded the Wal-Mart products and then left them in a pile.

The Ohio Environmental Protection Agency (OEPA) had originally advised Enviro that the process for recycling mercury-containing lamps would not have to comply with the state hazardous waste requirements because the materials would fall outside the definition of hazardous waste as a commercial product. Enviro was subsequently notified that since no significant recycling had occurred, the stockpiled materials were considered wastes. Moreover, since the lamps failed the toxicity characteristic leaching procedure test for mercury, they were considered hazardous wastes. Enviro was ordered to cease accepting the materials and to send the materials to a permitted hazardous waste facility. OEPA also notified Wal-Mart of the violations but the company continued to send materials to the Enviro facility for another month.

In 2000, the OEPA commenced an enforcement action against Paxton, Enviro and Wal-Mart. After Paxton remediated the property, OEPA dismissed the claims against the other parties. In 2006, Paxton filed an $850,000 contribution against Wal-Mart under Section 3746.23(B) of the state's Voluntary Action Program (VAP) as well as a number of common law claims. The trial court granted Wal-Mart's motion for summary judgment, ruling that Paxton could not bring a contribution action under the Ohio Revised Code because it had failed to comply with the statutory requirements for a voluntary action. Moreover, the court ruled that Wal-Mart had not violated the state version of RCRA because Enviro had assumed responsibility for the lamps pursuant to its agreement and that Wal-Mart was not negligent because a generator of solid or hazardous waste did not owe a duty of care to the owner of the property where a recycling facility operated.

On appeal, Paxton argued that a no further action letter was not a pre-requisite for bringing a contribution claim but instead simply established the statute of limitations. While the Ohio Court of Appeals for the Sixth Appellate District agreed that section 3746.23(C) of the Ohio Revised Code established a three-year period for commencing contribution actions, the court said that a "voluntary action" was defined in section 3746.01 of the Ohio Revise Code to include remedial activities followed by the issuance of a no further action letter indicating that the property meets applicable standards. Since a no further action letter from the OEPA was a statutorily required prerequisite to a contribution claim under Ohio Rev. Code, the appeals court affirmed the judgment of the lower court

Turning to the alleged hazardous waste violations, the appeals court said it was not until Enviro unlawfully stockpiled the lamps did the lamps and blinds become regulated as hazardous waste. Since the materials were merely commercial products prior to the unlawful speculative accumulation, the court said that Wal-Mart had not unlawfully transported or caused to be transported hazardous wastes to an unlicensed hazardous waste facility. Likewise, the court stated that Wal-Mart was not negligent because a generator of solid waste or potentially hazardous waste did not have an ongoing duty of care to the owner of the property where a recycling facility operated to monitor the management of waste once possession and responsibility was lawfully transferred. Similarly, since Wal-Mart was not a generator of hazardous waste at the time that it arranged for Enviro to transport the materials to the recycling facility, the court found that Wal-Mart was entitled to summary judgment on Paxton's common law contribution claim.

## *Pollution Exclusion Bars Coverage for Consultant Negligence*

In *James River Insurance Co. v. Ground Down Engineering Inc.*, 2008 U.S. App. LEXIS 17697 (11th Cir. 8/20/08), the Court of Appeals for the Eleventh Circuit held that a pollution exclusion provision in an engineering firm's professional liability insurance policy precluded coverage for third-party claims arising out of its alleged negligence in performing an environmental investigation.

In this case, the defendant was retained by Priority Development, L.P. ("Priority") to perform a Phase I environmental site assessment (ESA). The defendant did not identify any recognized environmental conditions. However, during development Priority encountered a significant volume of buried construction debris, several 55-gallon drums and a partial underground storage tank. Priority filed a lawsuit alleging breach of contract, misrepresentation and negligence. Priority asserted that it had incurred costs to remove the drums and associated contaminated soils and incurred extensive remediation costs from elevated levels of methane gas associated with the construction debris. The engineering firm submitted a claim to its insurer, requesting legal defense and indemnity. James River initially provided a defense under a reservation of rights but also filed an action with the federal court for the middle district of Florida seeking a declaratory judgment action that it was not required to provide coverage due to the pollution exclusion. This clause of the policy provided that there was no coverage for damages "arising out of the actual, alleged or threatened" discharge, dispersal, seepage, migration, release or escape of pollutants". The district court ruled that Priority's lawsuit fell outside the exclusion because the claim involved the failure of the insured "to carry out its professional responsibilities, not out of pollution". The court went on to say that it would be "unconscionable" to apply the exclusion to pollution that was not caused by the insured.

On appeal, the Seventh Circuit held that although the engineering firm did not actually cause the contamination and the claim involved alleged negligence in performing the site assessment, the Florida Supreme Court has ruled that "arising out of" language in the pollution exclusion clause was not ambiguous and should be interpreted broadly. The appeals court went on to say that the state Supreme Court had declared "arising out" was broader than "caused by" and had the meaning of "originating from, having its origins in, growing out of, flowing from, incident to or having a connection with." While the state court has stated that the "arisen out of something" requires some causal connection, the appeals court said the state court found that it was something more than a mere coincidence but less than proximate cause.

Turning to the policy language, the appeals court found that the claim clearly arose out of the presence of pollutants. The court said that Priority's complaint sought compensation for lost profits, lost property value and the significant funds it expended to remove contaminated soils as well as to monitor groundwater for contamination and methane gas. The complaint indicated that Priority had listed the injuries under the heading "environmental contamination". Although the alleged conduct was negligence, the court said the claims directly arose from the discovery of pollution dependent upon the existence of the environmental contamination. Finally, the court noted that various courts in other jurisdictions have held that the pollution exclusion applied where insureds were not the polluters. As a result, the appeals court said, the insurer that issued a professional liability policy had no duty to defend the engineering firm from negligence lawsuit.

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# HAZARDOUS WASTES

## *EPA Proposes To Regulate Pharmaceutical Wastes As Universal Wastes*

The EPA is proposing to add hazardous pharmaceutical wastes to the Universal Waste Rule in order to provide a system for disposing hazardous pharmaceutical wastes that is protective of public health and the environment.

The rule encourages generators to dispose of non-hazardous pharmaceutical waste as universal waste, thereby removing this unregulated waste from wastewater treatment plants and municipal solid waste landfills. The addition of hazardous pharmaceutical waste to the Universal Waste Rule will facilitate the collection of personal medications from the public at various facilities so that they can be more properly managed. This proposed rule applies to pharmacies, hospitals, physicians' offices, dentists' offices, outpatient care centers, ambulatory health care services, residential care facilities, veterinary clinics, and other facilities that generate hazardous pharmaceutical wastes.

Currently the federal Universal Waste Rule includes batteries, pesticides, mercury-containing equipment, and lamps. Universal wastes are typically generated in a wide variety of settings including industrial settings and households, by many sectors of society, and may be present in significant volumes in non-hazardous waste management systems.

***Commentary:** According to a recent report by the Associated Press, 46 million people may be exposed to trace amounts of pharmaceuticals in the nation's waterways and drinking water supply. As a result of the AP study, 27 metropolitan areas have begun analzying their drinking water supplies and 17 community water systems detected trace quantities of pharmaceuticals. However, the vast majority of municipal water systems -- including the nation's largest, New York City -- have yet to test their drinking water. Pharmaceuticals can enter municipal water supplies when they are discarded into toilets or through human waste. The drug residues can pass through sewage and drinking water treatment plants. While the aggregate risks are still unclear, researchers are discovering evidence that even extremely diluted concentrations of pharmaceutical residues harm fish, frogs and other aquatic species in the wild and impair human cell workings in the laboratory.*

# CLEAN AIR/CLIMATE CHANGE/SUSTAINABLE DEVELOPMENT

### *San Joaquin Indirect Source Rule Survives Two Court Challenges*

A federal district court upheld the Indirect Source Rule promulgated by San Joaquin Valley Air Pollution Control District (the District) in 2005. The Indirect Source Review (ISR) regulation, formally known as Rule 9510, and Rule 3180 (Administrative Fees for Indirect Source Review) were the first of their kind in California, They are designed to hold developers accountable for air pollution resulting from urban sprawl. These administrative fees are based on the notion that new commercial or residential developments will increase air pollution from the increased vehicle trips to and from the new developments.

The District has some of the worst air quality in the country, with non-attainment for three pollutants: PM10, PM2.5 and ozone. As a result, the District was required by EPA to develop a new attainment plan best available control measures (BACM). The District determined that Rule 9510 was necessary to achieve the mandated PM10 and ozone reductions. Emissions from vehicles account for 60% of the total air pollution emissions in the District. Other sources include construction of new projects stemming from equipment used for site preparation work, land scraping, grading, and compacting, increased energy usage, landscape maintenance equipment, wood combustion, increased motor vehicle traffic, and entrained dust from paved and unpaved roads once the developments become operational.

The ISR rule and its associated fee program were designed to reduce the impact of the growth in development projects thereby allowing the District to achieve state and federal air qualify standards by targeting indirect sources of air pollution. Rule 9510 does not apply to more traditional stationary sources such as factories, power plants, or manufacturing facilities but instead focuses on air pollution from non-point sources such construction and development projects. The ISR Rule applies to developments in the eight-county air basin that are expected to create a substantial amount of air pollution. The projects must involve a discretionary approval by a land use agency that ultimately results in construction of a new building, facility or structure. To be covered, the development project must exceed certain thresholds at full build-out. The thresholds are 50 residential units; 2,000 square feet of commercial space, 25,000 square feet of industrial space, 20,000 square feet of industrial or medical office space, 39,000 square feet of general office space, 10,000 square feet of government space, 20,000 square feet of recreational space, or 9,000 square feet of educational or uncategorized space. The Rule also applies to transportation projects whose construction exhaust emissions will result in a total of 2 tons of NOx or 2 tons of PM10 emissions. Construction equipment used for the project is also regulated.

The District developed a computer model to calculate a portion of the emissions attributable to a development project. Developers are encouraged to incorporate design features and on-site mitigation measures into their projects. If the developer incorporates such measures, emission reduction credits are given. If the developer reduces the requisite amount of pollution, no fee is charged. However, if emissions are left over after all mitigation measures, if any, are accounted for, a fee is assessed. This fee is based directly on what it costs the District to "buy" an equivalent amount of emission reductions off- site through its emission reduction incentive programs.

The ISR Rule also provides a mechanism for reducing air pollution emissions from the construction and use of development projects through off-site mitigation measures. The developer will be assessed a fee based on the number of tons of NOx and PM10 that are not mitigated by the developer through on-site features. The fee is used to "buy" equivalent reductions in NOx and PM10 off-site through the District's Emission Reduction Incentive Programs.

Thus far, the fees have average $400 to $500 per house but local building groups assert that some builders have been charged as much as $1,000-2,000 per house. In 2006, air district officials estimated the fees would generate more than $100 million from new construction over three years. The money pays for efforts to reduce pollution, such as retrofitting school buses and diesel trucks with cleaner engines.

In *National Association of Homebuilders v. San Joaquin Valley Unified Air Pollution Control District*, 2008 U.S. Dist. LEXIS 70931 (E.D. 9/18/08), the plaintiffs argued that Rule 9510 was pre-empted by the federal Clean Air Act since it required developers to use low-emission construction vehicles. The court began its analysis by explaining that the CAA authorizes states to regulate indirect sources of emissions (parking lots and garages) and to include indirect source review programs in their attainment plans. The court also noted that regulatory authority under the California Clean Air Act is bifurcated between the California Air Resources Board (CARB) and 35 local air districts, including the District. Under this framework, CARB sets state ambient air quality standards and tailpipe emissions standard for vehicles while the local air districts have "primary responsibility" to control other sources, including stationary sources and mobile sources "in use" through indirect and area-wide source programs and transportation control measures.

As part of Rule 9510, the District mandated mitigation of exhaust emissions from construction equipment greater than 50 horsepower to a level 20% below the statewide fleet average for NOx and 45% below the statewide fleet average for PM10. In addition, Rule 9510 provided that a project must reduce NOx emissions by 33.3% and PM10 by 50% during a ten years operational period following construction.

In bringing their lawsuit, the plaintiff alleged that its members use or subcontract to use construction equipment such as trucks, backhoes, earth-moving equipment, cranes, generators, and landscaping equipment powered by internal combustion engines greater than 50 and 175 horsepower. Since neither California nor the District had sought authority or obtained a waiver from EPA to regulate emissions of construction equipment and vehicles, non-road vehicles and engines, and motor vehicles and engines, the plaintiff claimed that Rule 9510 was pre-empted by the federal CAA.

The federal court ruled, though, that Rule 9510 was not a standard subject to pre-emption because it neither dictated permissible pollutant levels nor mandated emission control technology. The court said that Rule 9510 sets emissions targets for individual development projects, not individual engines. Although Rule 9510 may entice developers to purchase new engines, the court said the regulation does not mandate either acceptable engine or manufacturer requirements for new non-road engines or vehicles. The court said that Rule 9510 requires mitigation "through land use features and/or payment of an off-site mitigation fee".

Turning to the operational emissions targets, the court said Rule 9510 addresses reduction from current vehicle fleet emissions levels. The emissions reductions apply to the total associated area source and mobile source emissions regarding a project's operation, and are not an emission rate to limit an engine's emissions. The court found that the targets are cumulative emissions from a project emitted over 10 years. A developer's option to purchase or use cleaner vehicles does not render Rule 9510's emissions targets as standards to control vehicle emissions. For the same reasons, the court also rejected the notion that Rule 9510 adopted emissions standards or regulations under the guise of "indirect source review."

The decision followed a state court decision earlier this year in *California Building Industry Association et al vs. San Joaquin Valley Unified Air Pollution Control District*, No. 06-CE-CG-02100(Super. Ct- Fresno.). The state court rejected the plaintiffs' arguments that the rules were illegal development fees or taxes. Most interestingly, the plaintiffs had claimed that only the CARB had the authority under the Clean Air Act to regulated indirect sources. However, the court found that CARB had further delegated its CAA authority to the District and that the District was authorized to adopt more stringent requirements than those enacted by CARB. Moreover, the court held that the state Health and Safety Code provided that districts had the power to adopt "any strategy to reduce vehicle trips, vehicle use, vehicle miles traveled, vehicle idling, or traffic congestion for the purpose of reducing motor vehicle emissions." The court also noted that districts were also empowered to implement rules to regulate indirect sources of pollution by, among other things, encouraging ridesharing and alternative transportation.

## *Court Rejects EIS Because GHG Impacts Were Ignored*

A California state court invalidated an environmental impact report (EIR) for a 1,766-acre residential and commercial project that had been proposed for development in the northwest open space areas of Coachella Valley because the EIR had failed to analyze the project's greenhouse gas (GHG) emissions and other climate change impacts.

In *Center for Biological Diversity, et al. v. City of Desert Hot Springs, et al*., Case No. RIC 464585 (Super. Ct- Riverside Cty, August 6, 2008), the defendant had approved a 1,766- acre mixed-use development consisting of 2,700 homes, 1 million square feet of commercial space, a 400-unit hotel, a commercial amphitheater, and a 45-hole golf courses. The plaintiff and the Sierra Club challenged the project, arguing that the City of Desert Hot Springs had violated the California Environmental Quality Act (CEQA) by failing to make a meaningful attempt to analyze the Project's climate change impacts. The defendant had argued that a climate change analysis was not required because it would be entirely "speculative," given the absence of any formal regulatory guidance, framework, or the necessary analytic tools or methodology. However, the Court held that the City should have at least made a "meaningful attempt" to analyze the Project's climate change impacts. By failing to do so, the City did not proceed as required by law.

Relying on *Center for Biological Diversity v. National Highway Traffic Safety Administration*, 508 F.3d 508 (9th Cir. 2007) involving the analogous National Environmental Policy Act (NEPA), the court further held that the City should have considered the cumulative impact of GHGs. The Court did find that the EIR had adequately analyzed the project's impact on wildlife corridors and properly analyzed the project's water supply needs.

**Commentary:** *As of August 1, 2008, nearly 400 environmental documents in California have included discussion of a proposed project's climate change impacts. To date, lead agencies have taken various approaches in their climate change impact analyses - ranging from a qualitative or quantitative analysis without any significant determination to a quantitative analysis with a zero net carbon dioxide equivalent where the project's GHG emissions would be mitigated to zero or the project would rely on carbon offset.*

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