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REAL ESTATE & TITLE INSURANCE

Innocent Owner Protection: The Rules Get Stricter

To avoid liability for environmental cleanup, a purchaser must closely follow state and federal due diligence rules

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It is by now generally recognized that environmental due diligence by purchasers in commercial real estate transactions is essential for such purposes as preventing the purchaser from expending funds to clean up the property, avoiding business interruption if a remediation is required after the purchase, or discounting the purchase price if it later sells the property in a contaminated condition.

What is less commonly realized is that if a purchaser unknowingly purchases a contaminated site, it can be held liable as a responsible party for remediation expenses which may far exceed the purchase price of the property unless it closely follows the overlapping but divergent rules established by the New Jersey and federal governments as to what constitutes "due diligence."

Indeed, the lack of due diligence can also serve to reduce the recovery of a purchaser who discovers contamination on its site after the purchase and then seeks to pursue those parties responsible for the discharge for cleanup costs. The need to follow both the state and federal rules precisely to be able to qualify for "innocent owner" protection and try to avoid such liability is now highlighted by detailed, more exacting proposed rules to govern due diligence under federal law recently put forward by the United States Environmental Protection Agency

Spill Compensation and Control Act

A recent decision of the United States Supreme Court likely signals an end to litigation instituted under federal law by private parties seeking recovery for cleanup expenses unless there is an initial suit or cleanup order against these parties by the EPA, *Cooper Industries, Inc. v. Aviall Services, Inc.*, 125 S.Ct. 577 (2004). Since most environmental contribution actions will be brought under state law and because the NJDEP is in charge of most remediations in New Jersey, a purchaser in New Jersey must, therefore, be very aware of the requirements governing innocent protection status under the New Jersey Spill Act.

The protections in question, enacted in 1993 as amendments to the Spill Act, require those who purchased property after September 14, 1993, to perform a "Preliminary Assessment"(PA). If called for by that assessment, a "Site Investigation" must be undertaken to satisfy one of the conditions to qualify for innocent party status and thereby escape liability under the Spill Act for contamination that may be first discovered after the closing date. N.J.S.A. 58:10-23.11gd. Where the actual discharger is no longer in existence or is not financially viable, the absence of innocent party protection can lead to the non-discharging purchaser being responsible for paying the total cost of the remediation. Unlike federal requirements, the state's demanding due diligence standards apply also to residential buyers, thereby making the performance of a preliminary assessment prudent under such circumstances as when agricultural property is bought for the construction of homes.

The requirements of a preliminary assessment are set forth in the Spill Act and the more comprehensive technical regulations adopted by the DEP. N.J.A.C. 7:26E-3.1 et seq. The PA entails the completion of a detailed history of the site which must include evaluation of specified historical documents, if available, such as Sanborn Fire Insurance Maps and the MacRae's Industrial Directory, title documents, federal, state and local governmental

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files and other sources. A list of all materials, finished products, hazardous substances stored on the property, the location of such storage and all past and present production practices must be set forth. In addition, an evaluation of aerial photographs dating back to 1932, often most readily available only by traveling to the DEP's offices in Trenton, must be undertaken if the property in question is more than two acres in size. The site's regulatory history, including a history of all known discharges and remedial activities, must be compiled. Then, a site inspection must be performed to verify the information obtained, and a comprehensive report detailing the findings of the assessment and containing various attachments must be prepared in accordance with a format prescribed by the DEP. Among a multitude of other items, that report must compare contaminant concentrations in past testing to current remediation standards to determine if additional remediation is required even where a No Further Action letter was previously issued.

To date, the requirements of the PA have been more exhaustive than the commonly known "Phase I" Site Assessment prescribed by the American Society of Testing and Materials (ASTM). Many lending institutions have long required the ASTM site assessment and the EPA has designated Phase I as constituting "all appropriate inquiry" under federal law until the EPA's own rules on the subject are finalized. For example, the Phase I has not, to date, required the scope of document review, listing of materials and products previously stored and manufactured at the site, or the aerial photograph interpretations which are necessary to perform a proper preliminary assessment. As a result, consultants will typically charge more for a preliminary assessments than a Phase I.

If the preliminary assessment determines that further investigation or remediation is required, a purchaser must then perform a site investigation. Often thought of as a "Phase II" study, the purpose of the site investigation is to determine if contaminants are present or have migrated from the site, and whether further remediation is necessary. A site investigation requires that various prescribed sampling requirements be met. If contamination above regulatory levels is discovered, the test results must ordinarily be submitted to the DEP.

Given that a preliminary assessment is more comprehensive and costly than a Phase I and that many do not appreciate the difference between the two, it is questionable whether the New Jersey rules for establishing innocent protection status are being followed as routinely as they should be. It is true that by performing a preliminary assessment rather than a Phase I, a buyer who unknowingly buys a contaminated site will probably not escape all the negative financial ramifications of such a purchase. The buyer's financial investment in the property will still likely be impaired. However, the premise of the innocent owner defense under the Spill Act is that if a purchaser performs and documents the required studies, but learns of pre-existing contamination after the closing, the new owner will not be liable to the DEP or private parties for the cleanup if it complies with certain additional requirements, such as notifying the NJDEP about the discovered discharge. As a result, the buyer should have increased flexibility about how and when to deal with the contamination and will not be subject to the imposition of penalties by the NJDEP.

CERCLA

The Comprehensive Environmental Response, Compensation, and Liability Act was enacted in 1980. 42 U.S.C.A §9601 et seq. Since 1986, when the Superfund created by CERCLA was reauthorized by the Superfund Amendments and Reauthorization Act of 1986 (SARA), federal law has provided innocent purchaser status under CERCLA to those purchasers who exercise due diligence when buying a property. Following the amendment, the federal courts decided what constituted due diligence under the statute by making a case-by-case determination as to whether the buyer utilized good commercial and customary practices in performing the due diligence.

When the Small Business Liability Relief and Brownfields Revitalization Act was enacted in January 2002, Congress called for the promulgation of standards by the EPA within two years, setting forth exactly what is required for a buyer to conduct appropriate due diligence and thereby attain due diligence status. Congress mandated that the EPA include certain requirements in its due diligence regulations. These include inquiry into the historical uses of the property by an environmental professional, interviews with past and present owners and operators of the facility, review of historical sources to determine uses of the property since it was first developed, searches for environmental cleanup liens, review of federal, state and local government records and visual inspection of the facility and adjoining properties. 42 U.S.C.A. §9601 (35)(B)(iii). Further, the regulations must consider any specialized knowledge of the buyer, the relationship of the purchase price to the price of the property if it was not contaminated, commonly known or reasonably ascertainable information about the property and the degree of obviousness of the contamination. Id.

Until the new regulations are adopted, Congress provided that persons who purchased property after May 31, 1997, must have performed a Phase I pursuant to the ASTM requirements to qualify for innocent purchaser status. Persons who purchased property prior to May 31, 1997, will qualify for the innocent landowner defense if they exercised good commercial and customary practices of due diligence at the time they purchased the property. 42 U.S.C.A. §9601 (35)(B)(iv).

The EPA has now proposed regulations detailing what will be necessary for a purchaser to attain innocent purchaser status. 69 FR 52542 (proposed August 26, 2004). In its proposed regulations, the EPA expanded upon the requirements of the 2002 amendments

by requiring that the consultant overseeing the due diligence inquiries have certain educational and/or licensing qualifications and levels of experience. Because they may not have the requisite education and/or licensing under the federal standards, many environmental consultants who can continue to perform Preliminary Assessments under New Jersey law will be precluded from performing federal due diligence reviews. The proposed regulations have other requirements that are more burdensome than the current ASTM Phase I and New Jersey due diligence requirements. These include the requirement that interviews be conducted with neighboring property owners if the subject property is abandoned and an accounting and explanation of the significance of any data gaps. Further, a site assessment will only be valid for one year prior to the purchase, and the interviews, records review, search for environmental cleanup liens, site inspection and declaration by the environmental professional must be updated every six months to be relied upon in the final report.

The increasingly burdensome requirements for establishing due diligence and innocent purchaser status under state and federal law do vary. The obvious reality, however, that environmental cleanups may be very expensive and that pollution liability insurance for a buyer to pay for them is usually lacking, call for careful compliance by a qualified and experienced consultant with both sets of these rules. This is especially the case when the property in question has been the site of industrial, petroleum storage, agricultural or other operations that could reasonably have led to discharges of hazardous substances. By treating the due diligence process with the great significance that it deserves, a buyer who has not caused an environmental discharge can escape being deemed a party liable under the law to pay for the cleanup. ■