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REAL ESTATE EQUALS REAL CHALLENGES

THE ENVIRONMENTAL RISKS OF PROPERTY OWNERS

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Introduction

It should surprise no one that industrial sites represent significant environmental exposures. But even seemingly benign shopping centers, hotels and resorts, apartment complexes and office buildings can harbor unsuspected environmental problems. Some exposures are related current operations on the property while others may be the legacy of prior owners and tenants. When problems arise, owners are often surprised to discover that their general liability and property insurance policies offer little or no protection.

Real estate is intrinsically exposed to environmental risk. Even if a property is pristine today, events taking place on, around, or even deep beneath it may produce problems tomorrow.

To further complicate matters, the environmental risk landscape is perpetually shifting due to changes in environmental legislation, regulatory enforcement, case law, and social and political trends. Property owners typically are neither environmental engineers nor environmental lawyers, and they cannot be expected to stay abreast of all the changes affecting their risk profiles. Nonetheless, environmental risk management is a necessity. By being aware of the types of risks they are exposed to, and of significant developments in regulation and litigation, property owners can make better informed decisions about risk management, including decisions concerning environmental insurance protection.

Environmental exposures

Environmental risk is intrinsic to real estate. Even if a property is pristine today, events taking place on, around, or even deep beneath it may produce problems tomorrow. Often the risks are comparatively minor and manageable, but many environmental exposures hold the potential to spiral out of control, resulting in devastating losses to the property's owners. Many people equate pollution on property with soil or groundwater contamination, but real estate environmental exposures also include what happens inside buildings. In some cases, indoor air quality issues have resulted in lawsuits with demands in the hundreds of millions of dollars.

Stormwater runoff is one of the most significant environmental concerns for construction sites.

Some environmental exposures are an outcome of operations occurring on a site today. Hazardous substances – which can range from everyday products like cleaning fluids and insecticides to industrial byproducts – may be produced, used, or sold by tenants. Building materials may emit noxious gases, and potentially lethal bacteria and fungi may grow out of sight. Older buildings may contain asbestos insulation or lead paint.

Other exposures are an outcome of how property was used in the past. In some cases activities taking place on a site more than a century ago have left a toxic legacy for which current owners may be liable. Additionally, toxic chemicals that had leaked or been spilled on nearby sites may have migrated onto an owner's property over time.

Environmental exposures vary to some degree by property categories: construction and development sites, multifamily, retail, office and hospitality, and industrials.

Construction and development sites

Stormwater runoff is one of the most significant environmental concerns for construction sites. Runoff – which can contain diesel and oil; paint, solvents, cleaners and other harmful chemicals; and construction debris and dirt – is an important contributor to surface water contamination. The U.S. Environmental Protection Agency (EPA) has identified stormwater runoff as a priority issue, and the federal Clean Water Act directs states to implement stormwater management programs. Other construction-related environmental exposures include the use of various hazardous materials, and breaching unknown tanks or pipes when digging foundations and utility corridors.

Multifamily

The indoor environment can pose significant environmental risks in multifamily apartment buildings. Asbestos and lead paint in older buildings have been linked to severe health problems, leading to seemingly endless litigation and billions of dollars in settlements. Bacteria such as Legionella and fungi that can be transported through water sources, ventilations systems, and other means also represent serious risks. Formaldehyde from fiberboard, glue or other building materials; nitrous dioxide from gas stoves, space heaters and gas dryers; carbon monoxide from unvented kerosene and gas space heaters; leaking chimneys and furnaces; radon; pesticides; and various volatile organic compounds also can contribute to a potentially unhealthy indoor environment.

Environmental exposures associated with industrial sites are related directly to current and past operations.

Retail

Retail environmental exposures vary by the nature of the products sold currently or formerly at a location. Retail operations that deal in significant volumes of fertilizers, pesticides, paints, solvents, petroleum products and automotive batteries, for example, have a higher degree of environmental risk as a result of their operations than do, say, book stores or barber shops. In addition to environmental exposures arising from current retail operations, property owners should be aware of prior uses. A prime retail location may have been the site of a gas station or a dry cleaner in the past, and the soil may be contaminated by gasoline or by the toxic dry cleaning solvent, perchloroethylene.

Office and hospitality

Office and hospitality buildings have all the indoor environmental exposures of multifamily buildings. Additionally, older buildings may have problems such as toxic polychlorinated biphenyls (PCBs) in hydraulic fluid from elevators. Medical offices represent a wide array of exposures, including the storage of various hazardous substances and the presence of infectious medical waste. Resorts may have golf courses that use large quantities of fertilizers and pesticides that can contribute to stormwater runoff issues. As with all property, owners should understand how the land was used in the past and what types of legacy environmental problems could be present.

Industrials

Environmental exposures associated with industrial sites are related directly to current and past operations. Depending on the age and nature of the operations, soil and groundwater contamination may have a high likelihood of being present. Industrial properties typically pose the most varied and challenging environmental exposures. Many of the largest environmental claims arise from the improper storage and disposal of hazardous substances by manufacturing tenants.[1]

Environmental exposures lead to financial losses by property owners through a variety of channels. Violations of environmental laws can result in monetary settlements of enforcement actions, fines, penalties, and costs associated with injunctive relief. Individuals or companies claiming to have been damaged by pollutants on or from property may sue the owner under various legal theories. Environmental problems can seriously impair rental in-

Environmental exposures are regulated at all levels of government. Environmental laws typically fall into two categories: pollution control and remediation, and resource conservation and management.

come – driving away tenants and making it difficult to replace them, even after the problem has been addressed. Property owners also may spend large sums to voluntarily mitigate a problem before it gets out of hand.

Environmental laws and regulation

Environmental exposures are regulated at all levels of government. Environmental laws typically fall into two categories: pollution control and remediation, and resource conservation and management. Federal environmental laws typically set minimum standards, while state laws addressing similar exposures often are more stringent. Violations of environmental laws can expose property owners to settlement costs, fines, penalties, and the costs of injunctive relief actions.

At the federal level, three of the most significant environmental laws that may impact real estate ownership are the Resource Conservation and Recovery Act (RCRA), which is intended to provide "cradle-to-grave" control of solid and hazardous waste, the Comprehensive Environmental Response Compensation and Liability Act (CERCLA), commonly known as Superfund, which provides a regulatory framework for cleaning up contaminated sites, and the Clean Water Act (CWA), which establishes quality standards for surface water resources and gives the EPA the authority to regulate the discharge of pollutants.

RCRA's impact is largely limited to landowners with a waste treatment, storage or disposal facility on their property. CERCLA's reach is far more sweeping, and has the potential to create unexpected liability for almost any property owner. In practice, the EPA leaves the responsibility for the cleanup of the vast majority of contaminated sites to the states, which manage most cleanups under state Superfund laws or brownfields redevelopment programs. Property owners should be aware that under CERCLA and equivalent state laws, the current owner of a contaminated site and the owner of the site when contamination occurred are specifically identified as among the categories of parties potentially responsible for cleaning a contaminated site. Even if property owners are not at fault for causing pollution on their land, they can be held responsible for cleaning it up.

A federal environmental law that is likely to directly touch many property owners is the CWA. Any owner of a construction or development site needs to be aware of their responsibilities and potential liabilities as concerns stormwater runoff under this law. Stormwater runoff has been an area of emphasis by the EPA, which signaled its intent over the past year to vigorously enforce the law as concerns construction site runoff in actions against prominent regional homebuilders that resulted in large civil penalties.

Compliance with environmental laws and regulations is not the only – or even the most common – source of losses to property owners resulting from environmental exposures.

Every state has environmental laws that affect property owners. Beyond the state Superfund laws mentioned above, state environmental laws that can have an impact on real estate owners include those concerning wetlands, underground storage tanks, methamphetamine contaminated property, and indoor air quality. State and federal laws often overlap, raising the question of which should be applied. In most cases, states provide a level of environmental protection the same or more stringent than that provided by federal law. Unless the federal law specifically preempts state law, the more stringent state law will usually apply. [4]

Environmental laws also are promulgated at lower levels of government. County and municipal environmental laws, rules and regulations may address issues such as land use, groundwater management, stormwater management, outdoor burning, illegal dumping, and landfill usage.

Third party claims (environmental torts)

Compliance with environmental laws and regulations is not the only – or even the most common – source of losses to property owners resulting from environmental exposures. Owners are far more likely to find themselves sued under tort law. Plaintiffs in these suits may be unaffiliated third parties, but they are often the property owner's own tenants.

Tort law addresses situations where a person's behavior has unfairly caused loss or harm to someone else. An environmental tort arises when a person claims to have been injured through exposure to a toxin or a contaminant. Property owners can be named as defendants in lawsuits alleging bodily injury or property damage caused by exposure to toxic substances in, on, or emanating from land or a building under a variety of legal theories. Civil environmental liability often overlaps with regulatory environmental liability: allegations of negligence, for example, may be supported by claims that a plaintiff failed to meet certain regulatory requirements, and regulatory enforcement actions often trigger civil suits.

Toxic substances in building materials have been at the root of enormously costly lawsuits. Asbestos and lead paint have resulted in decades of litigation and billions of dollars in settlements. While not yet generating a large number number of lawsuits, other building products of concern include tritium exit signs, which use a radioactive isotope that may cause harm if ingested, inhaled or absorbed through the skin; and water-based latex paints that contain mercury to prevent the growth of bacteria. A U.S. Geological Survey report found that carcinogenic polycyclic aromatic hydrocarbons found in coal tar sealants were a "major source" of contamination in urban areas.[5] Property owners may believe that manufacturers of dangerous building materials and the contractors that installed them are primarily liable for damages.

Sick Building Syndrome, which has been identified as a specific matter of concern since the 1970s, refers to a situation where building inhabitants suffer from health problems that occur and are aggravated while in a building.

That is not always the case. In a significant 2003 asbestos case, a New York jury awarded the plaintiff $47 million. The defendants included owners of properties where the plaintiff had been exposed to asbestos.[6]

Sick Building Syndrome, which has been identified as a specific matter of concern since the 1970s, refers to a situation where building inhabitants suffer from health problems that occur and are aggravated while in a building. Sick Building Syndrome is often attributed to poor design, maintenance or a faulty ventilation system of a building. The Occupational Safety and Health Administration (OSHA) estimates that roughly 30 percent of the United States' 4.5 million existing commercial buildings may have air quality problems to varying degrees.[7] In one representative sick building case, county employees working in a privately owned building claimed to have developed upper respiratory infections, headaches, fatigue and sinus problems resulting in mild to permanent disability over a five to six year period. The plaintiffs brought a class action suit against the property owner, which resulted in a jury verdict of $1.5 million.[8]

Within the ambit of Sick Building Syndrome are illnesses caused by bacteria and fungi. Legionnaire's disease, caused by the legionella bacterium, was recognized in 1976 after an outbreak of pneumonia at an American Legion convention at the Bellevue-Stratford Hotel in Philadelphia. Legionella breeds in water and can be found in industrial cooling towers, central air conditioning systems, whirlpools, hot water systems, showers, architectural fountains, room-air humidifiers, and ice making machines. Legionnaire's disease lawsuits can be enormously expensive. In an August 2011 suit alleging 225 counts of negligence, eight guests of the Aria Hotel in Las Vegas – six of who claimed they contracted Legionnaire's disease while at the hotel – sued the hotel management company, the property owner, the property manager and the general contractor for $337.5 million.[9] Recently in Edinburgh, Scotland, an outbreak of Legionnaire's disease with 49 confirmed cases and 3 deaths is believed to have originated in a cluster of cooling towers in the southwest part of the city. [10]

Litigation involving mold skyrocketed during the first decade of the 21st century. The event that is often credited with the surge in mold-related litigation was a Texas jury that in 2001 awarded a family $32 million for property damage and mental anguish in a toxic mold case filed against their insurance company. (*Ballard v. Fire Ins. Exch.*).[11] Bodily injury claims in mold cases range from headaches and asthma, to neurological damage and cancer. Other damages sought can include pain and suffering, medical monitoring, lost wages, lost profits, loss of consortium, relocation expenses, attorneys' fees and punitive damages.[12] An early case, *Mazza v. Partridge Apts,* highlighted the potential exposure of apartment owners to mold claims. In 2001 a Sacramento County, CA jury ordered the investors and managers of an apartment complex to pay more than $2.7 million to three former tenants who claimed to have been injured by mold.[13]

A vitally important part of environmental risk management for property owners is, to the extent possible, to avoid liability for the action of tenants.

A growing problem for landlords in some parts of the country is methamphetamine manufacturers who move frequently and often leave behind contaminated property. The hazardous chemicals that are used to make meth, and the chemicals which are a produced during the manufacture of the drug, can seep into floors, ceilings, walls and duct work, and can remain for years.[14] In a growing number of cases, subsequent tenants sue their landlords for failing to disclose that the property had been used as a meth lab. Increasingly, states require disclosure as a matter of law.

Property owners should be aware that under some circumstances, they may be held liable in private lawsuits for the actions of tenants. If a property owner knows, or should know, about activities of a tenant that could be causing an environmental problem and does nothing to stop them, the owner risks being named as a co-defendant in a lawsuit. According to legal experts, common law tort principles require the owner of real property to prevent use of the property by others in an injurious manner.[15]

Other costs

Environmental problems of almost any type can have a significant impact on the value of property, in some cases rendering the property near-worthless. Even after contaminated property is cleaned, it may be stigmatized and worth less than similar property that was never contaminated. Additionally, landlords are likely to lose tenants once a problem is discovered, and may have trouble attracting new tenants after it has been remediated.

In an unusual but illustrative case, a property owner responded to a report by a tenant of a pungent odor and noises in the walls, and discovered that an exterior wall housed a colony of thousands of bats. The Health Department deemed the property uninhabitable because of poor air quality resulting from the ammonia in bat guano. The bats were a protected species and could not be exterminated. As a result, the building owner sustained substantial loss of rental income and diminution in property value. The owner eventually enticed the bats to leave by constructing bat houses.[16]

Environmental risk management

Perhaps fortunately for property owners, lenders provide a first tier of environmental risk management. The FDIC requires lenders to have an environmental risk management program, and examiners are required to review an institution's environmental risk program as

Environmental insurance protection should be an important part of the risk management program of property owners.

part of the examination of its lending and investment activities. While property owners can take comfort that a lender has vetted a property for its environmental risks as part of its lending due diligence, that is only the beginning of the risk management process, which should include, among other things, contractual risk allocation, pollution prevention actions and environmental insurance protection.

One of the most commonly used environmental risk management tools is a Phase I environmental site assessment (ESA), which now is a prerequisite for most commercial real estate transactions. A Phase I ESA identifies potential or existing environmental contamination by conducting a visual inspection of a site, evaluating the risks of neighboring properties, reviewing records, and interviewing people familiar with the property. Even if the environmental engineer who performs the assessment gives the property a clean bill of health, the owner should read the report carefully and not be reluctant to question anything that is unclear or that seems odd. The owner also should consider having an environmental attorney or environmental risk management expert review it as well.

Phase I ESAs are valuable tools, but property owners should recognize that they have limitations. A Phase I ESA is strictly an information gathering exercise – no physical testing takes place, so hidden contamination may be missed. Furthermore, the assessment is only as good as the engineer who conducts it – stories about engineers who missed an obvious exposure or who failed to recommend additional action on an identified exposure are legion. Relying on a faulty Phase I ESA is not necessarily a rock solid defense if something goes awry. Also, a Phase I ESA can identify risk, but does nothing to mitigate it. Environmental risk management needs to be a continuous process.

A Phase I ESA deals principally with soil and groundwater exposures, and offers very little insight into indoor pollution exposures. The EPA has released a guidance tool, the Indoor Air Quality Building Education and Assessment Model (I-BEAM), for use by building professionals and others interested in indoor air quality in commercial buildings. I-BEAM explains how to manage, operate, and maintain a building for indoor air quality. The Occupational Safety and Health Administration (OSHA) also provides guidance for preventing and controlling indoor air quality problems.[18]

A vitally important part of environmental risk management for property owners is, to the extent possible, to avoid liability for the action of tenants. Before leasing, the landlord should investigate the tenant's proposed operations with an eye towards potential environmental exposures. Leases should list prohibited activities, including a list the types of hazardous materials that are not allowed to be manufactured or stored on the premises. Leases also should have wording that maintains the landlord's right of entry onto the premises for inspec-

tion purposes. Landlords cannot contractually transfer CERCLA liability, but they can insist on an indemnity clause in a lease requiring the tenant to reimburse the landlord for cleanup costs. The landlord also should consider requiring the tenant to purchase environmental insurance.[19]

Once the lease is in effect, the landlord should exercise the right of entry to conduct periodic inspections. Additionally, site condition should be documented before and after a tenant occupies a property.

Issues such as indoor air quality exposures, mold, legionella and risks from historical operations may be the responsibility of the landlord rather than the tenant and therefore not addressable by lease indemnities and tenant insurance requirements. The landlord can purchase environmental insurance for their own benefit to address these exposures. General liability policies have an environmental liability gap as a result of the pollution exclusion found in most policies. Pollution Legal Liability policies can help fill that gap as concerns liability to third parties, and also provide coverage for pollution discovered on the insured's own property.

Conclusion

Property owners undoubtedly would prefer to concentrate on running their businesses without the distraction of environmental risk issues. However, the risks are real, and the outcomes of pollution events are potentially devastating. Whether as a result of their own operations, the activities of tenants, or the actions of contractors, property owners may find themselves facing potentially ruinous liabilities for situations they knew little about or over which they had little or no control.

Property owners cannot avoid environmental exposures. Even the most conscientious and risk adverse owners can inadvertently stumble into an environmental nightmare. However, by understanding their exposures and being diligent about environmental risk management, property owners can reduce the likelihood of having a serious problem, and will be better prepared to respond effectively if a problem arises. An important part of any environmental risk management program is insurance protection. Property owners should work closely with a broker with environmental expertise to assure they are buying the coverages most appropriate to their specific exposures from a well-qualified insurer. ■

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