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Contaminated properties becoming new investment niche in tight real estate markets

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A growing number of San Diego developers are realizing that getting their hands a little dirty can really pay off, especially in tight real estate markets (i.e., San Diego) that currently face land shortages and "cap" rates in the five or six range in low-risk niches such as apartments.

Of the estimated 500,000 contaminated sites that sit abandoned across the U.S., at least 100,000 sites are located in California — with estimates of fair market value in the hundreds of billions. And while the risk and hold times may not appeal to every investor, the rate of return can be substantial. Several recent changes have made the risk more manageable than it has ever been.

The acquisition of contaminated properties has become an increasingly important investment niche for savvy developers looking for better rates of return. Buyers and lenders alike are looking more closely at properties with environmental issues for two key reasons: 1) regulatory reforms, such as clearer guidelines regarding due diligence, have been implemented to reduce liability and increase protection for property owners; and 2) affordable insurance to adequately address environmental concerns increasingly has become available.

Regulatory reforms and due diligence

State and federal regulatory reforms regarding due diligence have been tailored toward helping developers understand and minimize liabilities, while providing for productive use quickly and inexpensively.

The driving force behind due diligence has historically been the Comprehensive Environmental Response, Compensation and Liability Act/Superfund Amendments and Reauthorization Act (CERCLA/SARA). Enacted in 1986, SARA serves as an addendum to the original Superfund law of 1980. To date, CERCLA, or "Superfund," has achieved the following: 1) established prohibitions and requirements concerning closed and abandoned hazardous waste sites; 2) provided for joint, strict and retroactive liability of persons responsible for releases of hazardous waste at these sites; and 3) established a trust fund to provide for cleanup when no responsible party could be identified. Superfund has always had an "out" by allowing the assertion of the "innocent landowner defense" to liability, requiring that "all appropriate inquiry into the previous ownership and uses of the property be consistent with good commercial or customary practice."

Until recently, the criterion to qualify as an innocent landowner was uncertain at best. Fortunately, recent amendments to Superfund clarify what constitutes "all appropriate inquiry." The Small Business Liability Relief and Brownfields Revitalization Act (the amendments) became effective in 2002. The amendments embrace the American Society for Testing and Materials (ASTM) Standard Practice for Environmental Site Assessment (E1527-97). The amendments require the Environmental Protection Agency to adopt regulations within two years that establish standards for appropriate inquiry. The EPA is currently working with stakeholders on this process.

Other liability clarifications, such as for "contiguous property owners" and "bona fide purchasers," also are included in the amendments, although their practical effects may be limited. Interestingly, the amendments specifically provide for the purchase of a contaminated property, while limiting liability if certain conditions are met.

For developers looking to acquire a contaminated property, performing due diligence means conducting a very thorough — and required — Phase I site assessment, which should meet or exceed the updated ASTM guidelines. A typical Phase I is conducted

by a qualified environmental consultant and includes site reconnaissance, interviews with on-site and off-site sources, regulatory reviews and thorough analysis of the site and site vicinity history.

Environmental insurance

Environmental insurance can cap liability and/or remove liability reserves from the balance sheet, thereby limiting risk to the buyer/developer and minimizing contingent obligations of the seller/property owner. Further, it provides a method to quantify economic risks associated with environmentally impaired properties, while enhancing access to debt capital.

Determining the best environmental insurance policy first requires an understanding of the risk management considerations for a particular contaminated property. Issues impacting parties to contaminated property transactions can include known, unknown and underfunded environmental liabilities; adverse development of known environmental liabilities; and pending litigation. The four major types of environmental insurance coverage are outlined below:

1. **Cost Cap/Stop Loss.** This type of coverage works for anyone involved in remediating contaminating properties. It minimizes uncertainty by paying for defined cleanup costs that exceed the anticipated cost of cleanup. It also provides a buffer above the expected cleanup costs. A remedial action plan is usually a prerequisite to obtaining this type of coverage.

2. **Environmental Impairment Liability.** EIL coverage is site specific and covers first and third parties. It covers both pre-existing and new claims for known conditions. Policy terms can extend up to 10 years, with coverage ranging from \$15 million to \$100 million.

3. **Finite program.** The entire expected cleanup costs may be included in a finite insurance program. It usually is recommended for larger projects (\$4.5 million to \$5 million and up), although small projects are sometimes considered. A finite program requires a remediation action plan and accurate estimation of annual cleanup costs.

4. **Lenders coverage.** Two major concerns of lenders regarding environmentally impaired properties are the potential environmental liability and compromise of their collateral. Secured creditor insurance is designed to protect lenders from loss of collateral value; the inability of the borrower to repay the loan; and liability of environmental conditions on foreclosed properties. Lenders coverage might make lenders more willing to provide capital on contaminated properties.

Prime investment sites

Sites with leaking underground storage tanks (LUSTs) are excellent redevelopment candidates. There are more than 30,000 LUST sites in California, with thousands of sites in San Diego. Interestingly, LUST remediation often can be reimbursed through a state cleanup fund, or sometimes can be covered by insurance. Risk-based corrective action may facilitate the redevelopment and cleanup of these sites.

"Contiguous property," such as contaminated groundwater sites, also can be prime investment opportunities. Taking ownership of property located over contaminated groundwater from an adjacent site is not necessarily problematic for developers if the subject site did not cause or contribute to the contamination. While some lenders may be wary of these sites, obtaining a "comfort" letter from an environmental agency may rectify the situation.

In addition, almost all urban areas encompass numerous brownfield properties in need of remediation. With increasing demand for "in fill" development opportunities, soaring housing prices and pressure for "smart growth," urban

cores are prime locations for the acquisition of redevelopment and brownfield properties.

For example, Environmental Business Solutions was retained by Centre City Development Corp. to perform historical and regulatory research of the 35-block portion of downtown San Diego's East Village Redevelopment area, which encompasses the 7-block footprint of the new San Diego Padres ballpark. Contamination stemming from a history of commercial and industrial uses dating back to the 1800s was discovered through Phase I and Phase II site investigations. The remediation project, which has garnered several awards, is part of a \$1 billion redevelopment effort to revitalize East Village, making it the largest project of its kind ever conducted in California.



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Getting the deal done

Once due diligence efforts and possible insurance coverage have been examined, buyers/developers still must determine how to incorporate them into the overall acquisition process.

Strategies for executing the transaction in an orderly and efficient manner are outlined below:

- Consider retaining an independent consultant to review or manage the due diligence or remediation process (most small to medium-size developers do not have these internal resources);
- Consult with financing sources to understand their needs upfront;
- Consider environmental insurance;
- Obtain seller disclosures and be sure to collect all available information;
- Incorporate risks and known areas of contamination into a project design to help minimize remediation costs;
- Evaluate legal protections and include all available possibilities;
- Determine agency participation in case agency oversight is required;
- Select a cleanup program and define in it the scope of work;
- Contract for all remediation and demolition work;
- Allocate cleanup costs and establish workable cleanup standard; and
- Evaluate disclosure obligations to determine what to say to prospective tenants or buyers, once the property is acquired or redeveloped.

Needless to say, real estate investments always carry their share of risks. For developers considering contaminated property acquisitions, the desired rate of return must be balanced against such factors as time constraints, limitations of land use, scope of necessary due diligence, liability risks and insurance costs. Keep in mind that the fundamentals of any real estate transaction still apply. Some properties are truly "upside down" and, even if available at zero cost, are not worth it. However, for the savvy investor, "dirty dealing" can be an interesting and rewarding experience.

Johnson is founder of environmental consulting firm Environmental Business Solutions, a wholly owned subsidiary of SCS Engineers. More information about the company can be found at www.ebsenvironmental.com or www.scsengineers.com.