

# Minimizing Commercial Lease Risks Through Proper Environmental Due Dilligence

By Michael A. Nesteroff

As real estate development and leasing begin to emerge slowly from the dark days of the Great Recession, it's important to remember that environmental considerations should not take a back seat to getting a deal done. In commercial leasing, just as in the purchase-and-sale context, parties disregard or minimize environmental issues at their peril. While there are many good reasons for doing some environmental due diligence, the primary reason can be summed up in five words — joint and several strict liability.

The Washington Model Toxics Control Act (“MTCA”), as well as federal statutes such as the Comprehensive Environmental Response Compensation & Liability Act (“CERCLA”), encourage, with a somewhat heavy hand, the expeditious cleanup of contamination. Liability under both MTCA and CERCLA can arise solely because of a party's status and without regard to whether the party caused contamination.

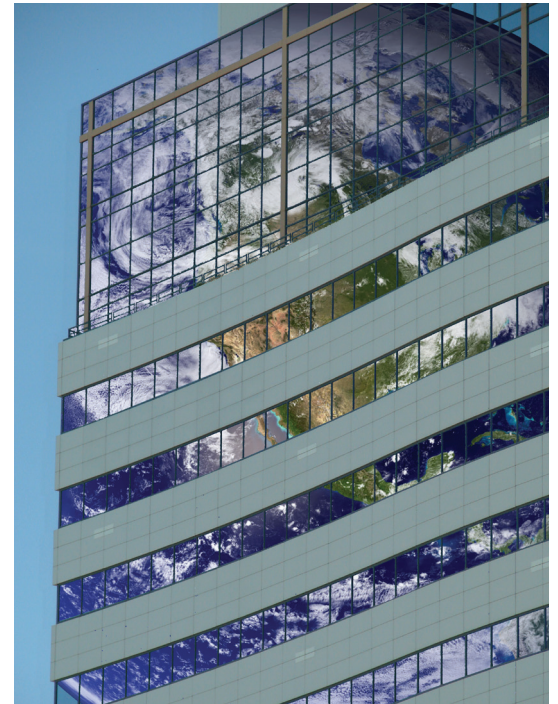
The statutes are broad enough to sweep up a lessor or tenant, even if neither of them actually caused a release of hazardous substances. Faced with the prospect of joint and several liability, a current owner or operator could be left with the whole tab for investigation and cleanup, as well as their own attorneys' fees and costs and those of any prevailing party if litigation results.

Thus, commercial landlords and tenants need to know as much as they can about the property's environmental condition before the lease commences, what operations will take place on the premises that might cause environmental contamination, and who is to be responsible for any investigations and cleanup so they can negotiate lease provisions accordingly.

## Due Diligence

How much due diligence is necessary depends on what is being leased. A tenant in a shopping center or strip mall usually doesn't need a full environmental site assessment; but a ground lease tenant who will be developing a site should consider an extensive review. At a minimum, any prospective tenant should determine if there are any reported releases or cleanups and do a walk-through of the site to identify whether any potential red flags exist.

Documented releases of a hazardous substance can be found in one of the Washington Department of Ecology's on-line databases. The Facility/Site Database, <http://www.ecy.wa.gov/fs>, and the Cleanup Site Search page, at <https://fortress.wa.gov/ecy/gsp/SiteSearchPage.aspx>, provide access to information about a location or operation that has an active or potential impact on the environment, including state cleanup sites, federal Superfund sites, hazardous waste generators, solid-waste facilities, underground storage tanks, dairies and enforcement activities.



A site walk-through also can help identify if there are any indications of lurking environmental problems. Typically, this involves looking at what activities may have taken place on a property that could give rise to an environmental cleanup and checking nearby properties. Things like unmarked drums of chemicals with stains underneath, chemical odors or dead vegetation are all warning signs of potential problems.

A more elaborate environmental investigation involves a Phase I Environmental Site Assessment and, if necessary, a follow-up Phase II site investigation.

A Phase I investigation is primarily a document search and site walk-through, but with a more extensive, formalized process that is the by-product of the federal Environmental Protection Agency's "all appropriate inquiry" or "AAI" rule. The components for satisfying the AAI rule in a Phase I are contained in ASTM Standard E 1527 05 and include:

- certification by a qualified environmental professional;
- interviews with past and present owners and operators of the property;
- visual inspection of adjoining properties;
- a search for any environmental liens and historical research covering the uses of the property back to first development;
- assessment for controlled substances (such as meth labs);
- assessment of the tenant's or operator's specialized knowledge; and
- identification and evaluation of data gaps.

Under the AAI rule, a Phase I is good for one year, although interviews, on site visual inspection, historical records review and search for environmental liens must be updated within 180 days before the deal closes.

If a Phase I identifies one or more "recognized environmental conditions," a Phase II Site Assessment may be necessary to identify the scope and extent of any actual contamination. This typically involves some form of invasive activity, such as drilling or digging into the substance, to determine whether and to what extent there are hazardous substance impacts to soil or groundwater.

In a commercial lease transaction, such invasive testing can be seen by lessors as opening Pandora's box but, when a Phase I identifies recognized environmental conditions, it can be absolutely critical for the prospective tenant deciding whether to move forward.

### **Lease Provisions**

Armed with the information from a Phase I and, if needed, Phase II, the parties can negotiate the terms of the environmental provisions in the lease. For the tenant, the goal is to make sure that it is not stuck with any costs, including business disruption, from preexisting environmental conditions.

For the landlord, the goal is to eliminate any liability that might arise from a tenant's operations on the property. The Phase I/II investigations set the baseline for the parties to know what is present on the property before the lease begins and become the benchmark against which they measure any future releases of hazardous substances and apportion liability.

In addition to a provision for compliance with all laws, most commercial leases also contain a specific provision regarding the use and presence of hazardous substances on the premises. In this provision, the parties spell out the definition of hazardous substance and what their respective obligations are to clean up a release.

One area of friction between lessors and tenants can be in the definition of hazardous substance. Some leases define hazardous substance as anything that exceeds a specified threshold, such as an established cleanup level. Some lessors, however, may want a much broader definition that includes any quantities or concentrations of hazardous substances and could include those used in the ordinary course of business, such as ordinary fuels, lubricants, coolants, brake fluid, transmission fluids and the like. This presents a problem for many tenants because it makes them responsible for every molecule of a hazardous substance without taking into account whether the amount present constitutes a threat to human health or the environment.

Some provisions can be specific about the cleanup standard and what constitutes “clean.” Some leases may require that a tenant obtain a No Further Action (NFA) or other similar determination from the Washington Department of Ecology, which has developed nine different opinion letters for independent remedial actions, and it may require substantial time and expense to obtain one.

Even then, an NFA is something less than a shield against all claims. For example, an NFA does not resolve a party’s liability to the state under MTCA, unless it happens to be part of a settlement with the state as part of a consent decree under RCW § 70.105D.040(4). Nor does an NFA protect a party against contribution claims by others, except when the party has entered into a consent decree.

Finally, getting to an NFA can take time. If groundwater is contaminated, Ecology requires that there be four consecutive quarters of monitoring well samples below the cleanup standards before it will consider issuing an NFA. If the site has any problematic contamination, for example from a former dry cleaner, getting to the four quarters of clean samples can take a considerable period of time. Thus, requiring that a tenant obtain an NFA may prolong the termination of the lease, and certainly cause substantial expense.

Environmental due diligence also is useful in determining the scope of any indemnity provision. While many parties to a real estate transaction believe a standard indemnity provision covers potential environmental exposure, Washington case law teaches that the prudent practice is to have a separate environmental indemnity provision.

Furthermore, unless expressly stated otherwise, environmental indemnity provisions only cover those losses the indemnitee is required to pay to a third party who is unrelated to the transaction. If the parties want indemnity protection for their own activities, the provision must clearly state that.

An environmental indemnity provision in a lease should address all costs that might be incurred, including some that may not fit into the typical definition of “site cleanup,” such as assessment costs, post remediation monitoring, agency negotiations, site access issues and general legal fees. A good environmental indemnity also details how assessment and cleanup work will be performed, by whom and on what timetable. The parties also need to negotiate the length of an indemnity, which is extremely important with environmental conditions that can linger for many years.

Indemnities, of course, are only as valuable as the financial health of the party giving the indemnity. If the party granting the indemnity has a marginal balance sheet, the other party may need some form of security, such as a bond, escrowed funds or environmental insurance. The most effective way of allocating environmental risk is to quantify the risk and either add it to or deduct it from the rent.

The parties may also want to include some other provisions in the environmental section of a lease. Among those are deciding who has the obligation to report and disclose contamination, a right of inspection by the lessor and a certification upon vacancy.

In summary, long before a commercial lease is signed, it's critically important that the parties to the transaction make sure they are armed with all of the key information that thorough environmental due diligence will give them. There are no advantages for cutting corners when the costs, monetary and otherwise, of environmental investigations and cleanups are so substantial.



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