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**Understanding Risk Sharing Mechanisms
for Brownfields Redevelopment**

by

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ABSTRACT:

One of the negative consequences of the Industrial Revolution in the United States is that numerous sites that once housed heavy industry now lie fallow. Investors have avoided such sites for fear of exposing themselves to the “strict” and “joint and several” environmental liability under CERCLA legislation. However, new government programs established to correct the “brownfields” problem have begun to attract private capital and renewed interest in brownfields redevelopment.

The ability of private capital to flow into brownfields is contingent on the mechanisms available to the participants to distribute the environmental risk and reward of the project. This thesis explores how private market investors analyze and distribute these risks through a close examination of the documents utilized for two such projects. The research has been conducted as part of a larger study in which a total of six case studies have been investigated. All six cases will be utilized in the final chapter.

The first case study involves the remediation and redevelopment of a former oil tank farm into a residential subdivision. The site had been contaminated by the U.S. Navy, and was partially being remediated by the Department of Defense. This case provides a good example of how a buyer can utilize non-recourse, seller financing and a state voluntary program to protect its interests throughout the project.

The second case looks at the acquisition of an office portfolio by a REIT. This portfolio included an undeveloped parcel of land that had been contaminated by an adjacent site. To provide the funds necessary for the remediation of the parcel, the buyer required the seller to set aside proceeds from the sale. By establishing the escrow account, the REIT eliminated the risk of the Seller dissolving after the sale. Furthermore, since it utilized the state voluntary remediation program, the REIT had a defined standard of remediation required that would cap its future liability.

The cases offer four principal lessons: 1) government agencies can assist private investors get past many major hurdles; 2) although environmental insurance is a tremendous risk sharing mechanism, it is currently not being utilized in a significant way; 3) state voluntary programs are being utilized by most investors; and 4) deep-pocketed principals need to retain control of the remediation process.

Thesis Supervisor: Lawrence S. Bacow
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CHAPTER 1

Brownfields

Introduction

One of the negative consequences of the Industrial Revolution in the United States is that numerous sites that once housed heavy industry now lie fallow. Given the terrible financial condition of many of the Nation's older cities and suburbs, these "brownfields" represent an intolerable waste of valuable resources. "Brownfields are defined as previously occupied industrial sites that are contaminated or thought likely to be contaminated and are currently vacant or underused."¹ Many of these sites became contaminated when operators were ignorant or less vigilant concerning the proper disposal of industrial by-products. According to Environmental Warranty, a Connecticut-based company that insures against unexpected environmental cleanup costs, approximately 450,000 properties nationwide are either contaminated or suspected of being contaminated.² Furthermore, it is estimated that the cost of remediating these sites will total \$650 billion.

Since these sites do not produce taxes or economic goods (e.g., employment, products, etc.), all levels of government are interested in solving this problem. By initiating brownfield redevelopment, public agencies can create new sources of employment, prevent "clean" sites or so-called "greenfields" from being developed, and increase future property and income tax revenues.

Government Response

In order to deal with this ever-growing problem, the federal government enacted the

¹ Chalmers, James and Thomas Jackson. "Risk Factors in the Appraisal of Contaminated Properties," The Appraisal Journal, January 1996, page 57.

² Allen, Scott. "Waste sites now paying dividends," The Boston Globe, 16 November 1996, page A1.

Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA or Superfund) in 1980. With this legislation came the obligation of current and previous owners to clean the contaminated sites. Under CERCLA, liability is strict (e.g., without regard to fault) and is applied “jointly” and “severally.” Therefore, it reaches beyond the “responsible parties” and effectively includes all owners who are in the chain of title. Although there have been stories of start-up companies and innocent operators being sued for millions of dollars of remediation costs, typically the government pursues larger, deep-pocketed firms and responsible parties.

Furthermore, although the language of CERCLA protects lenders who hold security interests in contaminated properties, judicial interpretation has varied. In *United States v. Fleet Factors Corp.*³, the court broke with existing precedent and held that a secured creditor could be liable under CERCLA if its involvement was sufficiently broad enough to affect hazardous waste disposal decisions. This 1990 judicial decision sent shock waves through the lending community.⁴ The uncertainty of liability combined with the difficulty in raising capital for these contaminated properties has caused many sites to remain vacant and unproductive.

Over the past few years there have been a number of programs established to address the brownfields problem. “The Environmental Protection Agency (EPA)...is supporting brownfields pilot projects that are allowing local governments to experiment with funding, cleanup, and public involvement scenarios.”⁵ By 1995, the EPA had 50 pilot demonstration programs in effect nationwide. Through the end of 1996, the EPA had issued 78 project

³ United States v. Fleet Factors Corp., 901 F. 2d 1550.

grants worth over \$13 million.⁶ These pilot projects have attempted to motivate individual states to initiate their own brownfield redevelopment programs. Furthermore, the EPA has taken steps to offer liability protection to new owners (so-called prospective purchasers) and has issued a policy that clearly delineates the parameters for lender liability (so-called “bright line” test).⁷

Unfortunately, regardless of the public good to be achieved, any significant level of brownfields redevelopment can only occur with the involvement of the private sector. Private capital will invest in brownfields if the risks associated with the investment are commensurate with the project’s overall return.

In the last few years, a number of joint ventures between real estate and environmental firms have been created to capitalize on the anticipated high returns from brownfields investing. These teams are created to buy distressed properties at a discount, remediate them, and develop or sell them at a profit. This recent flurry of private sector activity suggests that significant arbitrage opportunities may exist in the redevelopment of brownfields.

Recent Stimuli

Essentially three catalysts can stimulate investment in brownfields: decreased costs, decreased risks, or increased returns. Currently, advancement in all three categories has taken place in both the public and the private sector.

Second only to litigation expense, remediation costs can be a brownfields “deal

⁴ Bartsch, Charles and Elizabeth Collaton. Brownfields – Cleaning and Reusing Contaminated Properties. (Washington, D.C.: Northeast-Midwest Institute, 1997).

⁵ Ibid.

⁶ Wright, Andrew and Andrew Roe. “Brownfield Cleanups Debug Development,” Engineering News - Record, April 28, 1997, page 34.

⁷ Diamond, Bruce. “Opportunities in Brownfields,” Mortgage Banking, July 1996, page 90.

breaker.” Minimizing the expense of site remediation has been realized recently through legislation and technology. One such piece of legislation is the Risk Based Corrective Action (RBCA). This legislation, commonly referred to as the Rebecca Laws, allows for the remediation of a contaminated site to be custom fit for its proposed redeveloped use. For example, if the site will be used as a retail center at completion, the level of remediation will not have to reach that of a proposed residential housing development. By setting the appropriate level of remediation to the project’s end use, the remediation costs can be lowered in most cases.

Recent technological advances in the environmental remediation field have led to more efficient remediation tactics and thus lower cleanup costs for brownfield investors. In Italy’s northern Po Valley, about 35 kilometers west of Milan, engineers used a four-pronged approach for the cleanup of a devastating oil spill. When a major oil well exploded in 1994, this farm community was covered by millions of gallons of crude oil over a range of five square miles. Many of the tactics used, such as in situ “landfarming” and biopiles⁸, helped to fast-track the cleanup efforts and return more than 90% of the tainted fields back to the farmers in time for the 1995 spring planting.⁹ Although most brownfields do not require such advanced bioremediation approaches, the lessons learned from these projects will help engineers understand how to remediate other brownfields in a thorough and efficient manner.

Environmental insurance can play a significant role in the redevelopment and transferability of contaminated properties. Environmental insurance policies can be utilized to lower a project’s risk by capping the cost of site remediation. By doing so, a portion of the

project's risk is parceled out to another player (e.g., insurer) for a fee. In addition, an investor can purchase a policy that will protect against future liability. Johnson and Higgins, an insurance-brokerage and risk management firm based in New York, offers a single policy for all parties involved in a brownfields redevelopment. This "dirty wrap-up" coverage gives the developer more control over the project and typically lowers the overall cost of environmental insurance for the entire project.

According to Charles Perry, founder of Environmental Warranty Inc. of West Hartford, Connecticut, "the price of environmental insurance has dropped at least 75% over the last four years, largely because true cleanup costs often come in below what people fear."¹⁰ In addition, the use of environmental insurance can be used to ease the fears of a potential buyer.¹¹ In one such deal, Perry's firm issued an environmental insurance policy in favor of the buyer. The buyer accepted this policy in place of an environmental indemnification from the seller, and the sales price was discounted by the price of the coverage.

Further advancement in decreasing the risks associated with the redevelopment of brownfields has been achieved at the state level. For example, many states currently have their own voluntary cleanup programs. "Voluntary cleanup laws are one of the most prevalent regulatory changes speeding along brownfields redevelopment where enforcement programs have failed."¹² These programs allow parties to initiate site remediation under state cleanup

⁸ In situ "landfarming" utilized the local farmers to aerate and fertilize the soil. This process provided much needed nutrients and oxygen to the bioremediation activity. Biopiles are mounds of soil with layers of piping that allow for tight control of critical moisture, oxygen, nutrients and temperature.

⁹ Rubin, Debra. "Bugs Feast in Italy," Engineering News - Record, April 28, 1997, page 46.

¹⁰ Allen, Scott.

¹¹ Sheridan, Mike. "How is the Real Estate Industry winning the Brownfields Battle?" National Real Estate Investor, August 1996, page 72.

¹² Author unknown. "States take the lead in Brownfields," Environmental Business Journal, February 1997, page 4.

standards. Upon completion of remediation, most states typically issue a “No Further Action” letter that can lead to a “Certificate of Completion.” Massachusetts privatizes its cleanup program by requiring the parties to hire an independent site cleanup professional. This professional oversees the site remediation and issues a “No Further Action” letter to the investor upon completion. The state is notified throughout the project by the independent professional regarding the project’s status.¹³

A “No Further Action” letter and a “Certificate of Completion” however do have their limitations. For example, they do not protect past owner/operators of the property, only the party who initiated the remediation and all future owner/operators. Furthermore, because the state government issued the “No Further Action” letter and the “Certificate of Completion,” they do not provide liability protection from the federal government or third-party suits under federal environmental laws. To address this concern, the EPA has stated publicly its intention not to interfere at sites that are participating in state voluntary cleanup programs. The regional offices of the EPA have begun issuing “comfort language” in their Memoranda of Agreement with states that have achieved a level of proficiency in overseeing site remediation programs.¹⁴

The final catalyst for increased brownfields redevelopment is higher financial returns. Increased returns can be achieved through many new federal, state, and local programs that are created to be brownfields redevelopment initiatives: tax credits, grants, public-sector funds, tax abatements, empowerment zones, etc. In addition, the issue of whether remediation costs can be deducted or must be capitalized has been at the forefront of many Internal Revenue Service and Congressional discussions. Assuming that pending legislation passes in

¹³ Bartsch, Charles.

favor of remediation cost deductions, the resulting increases in investor yields will initiate a boon of new brownfields redevelopment.

Risks

All real estate development transactions entail risk. These typically include:

- Approval risk – the risk that the project will not receive the public approvals necessary to commence construction and occupancy;
- Construction risk – the risk that the project will not be built on budget or on time;
- Interest rate risk – the risk that interest rates will rise during the construction and lease-up period in excess of budget thus necessitating infusion of additional capital;
- Market risk – the risk that the project will not generate the expected cash flows in the marketplace either due to slower than expected lease-up or sale, or due to lower than expected rents or sales prices;
- Operating risks – the risk that the cost of operating the project once constructed will be in excess of budget.

In addition to the above, brownfields entail special risks. For example, investors in a brownfield project face risks of future environmental liability that are typically far greater than encountered in the development of “greenfields.” Similarly, one of the operating risks incurred by brownfield investors is the risk of future remediation costs either due to discovery of additional wastes on site, or due to adoption of more stringent future regulations. Finally, investors in a brownfields redevelopment face different market risks. Will the stigma of the past environmental problems cause the property to trade at a discount? Are tenants willing to locate their operations on sites with troubled environmental histories?

Investor Motivation

¹⁴ Pepper, Edith M. Lessons from the Field – Unlocking Economic Potential with an Environmental Key. (Washington, D.C.: Northeast-Midwest Institute, 1997).

Given the barriers to brownfield redevelopment posed by the above risks and costs, these projects require the involvement of a broader range of investors than traditional development projects. Investors in this context include all parties who are making a financial investment in the site. These include equity investors, holders of debt, insurers, remediation and general contractors, tenants, and in many cases, public entities that are bearing part of the cost of cleanup or redevelopment.

One positive aspect of involving a myriad of investors into a brownfields project is that each investor has a different method of evaluating the specific components of risk involved in the deal and a different level of tolerance for such risk. As such, there might be a way to parcel out the pieces to those who are willing to assume the risk for the lowest return and therefore pay the highest price. The late William Zeckendorf, a highly successful real estate investor, used to refer to this method as the Hawaiian Technique. By selling the component of the project to the investor who understands the risks best, the promoter or lead investor can generate the highest value for the project.

When assembling a team to conduct brownfields redevelopment, one has the option of creating this team internally or externally. As mentioned earlier, a number of joint ventures between real estate and environmental firms have been created. By bringing all of the experts together, these firms believe they will be best suited to capitalize on the flurry of brownfields activity. However, by putting together the right team of professionals, any real estate investment firm can participate in these deals. As long as there is a clearly defined process and end use, most firms will be able to participate in the future of brownfields redevelopment.

Methodology

As one member of a three-student team, we propose to undertake a series of case

studies of brownfields redevelopment.¹⁵ The purpose of these case studies is to understand how the financial structures employed by the principals allocate the risks and rewards associated with these transactions. These instruments include partnership and joint venture agreements, incorporation documents, purchase and sale agreements, option agreements, mortgages and other debt instruments, remediation contracts, indemnification agreements, leases, and insurance. In addition, we will also be evaluating the impact of any legislative initiatives designed to address the risks assumed by new investors.

The case studies that will be used for this thesis must meet certain criteria. For this particular paper we are interested mainly in brownfields, not the heavily contaminated Superfund sites. The project must have reached the point where all essential documents have been negotiated and signed. Although we are not requiring that remediation work and construction have begun, it is necessary to have the project permitted and financed. By requiring our case studies to fall within these guidelines, we can isolate our research and inquiries through the finalized documents.

Due to the sensitive nature of many brownfields projects, it was necessary to mask some of the case studies to protect the identity of the principals and the project's location. The disguise was handled in one of two different ways. In some instances, the names and locations were changed to different ones. In other cases, no name was used to describe the principals and locations.

In the final chapter, we will pull together the lessons learned through all of the case

¹⁵ The first two case studies which are discussed in the final chapter are from "Risk Sharing in Brownfields Redevelopment: a case study approach," a 1997 Master Thesis of the MIT Center for Real Estate authored by John M. Evans. The latter two were authored by Shaun Ryan and are presented in "Brownfields Development," a 1997 Master Thesis of the MIT Center for Real Estate.

studies. The collection of these cases should provide for appropriate comparisons and contrasts. Of the six case studies conducted, we encountered four different states, four different end uses (e.g., industrial, office, recreational, and residential), and principals in many different forms (e.g., government, private, public REIT).

Relevance

Most of the work to date on brownfields has ignored the financial dimensions of these transactions. From the public sector's perspective, much of the interest in redeveloping brownfields stems from a number of objectives including reclaiming dirty sites, protecting greenfields from development, creating jobs and tax revenues in blighted areas, and stimulating additional development through brownfield reclamation. Unfortunately, this agenda does not always dovetail with the agenda of the private sector, which typically view brownfields as a development opportunity to be evaluated in terms of risk and reward. It is important to reiterate that private capital will only invest in brownfields if the risks associated with the investments are justified by the potential financial rewards.

The purpose of the proposed research is to better inform our understanding of how the various actors in the brownfield redevelopment process, assess, and evaluate the risks associated with these investments. By examining the financial documents used to allocate these risks, we hope to understand how public policy might be crafted to stimulate more brownfields redevelopment in the future.

CHAPTER 2

Risk Sharing Mechanisms

Through a series of bilateral and multi-lateral agreements, the many parties in a real estate development project determine how risk and reward will be parceled out during the project's life. This is of major concern to parties involved in a project with past environmental problems. By describing each document and relationship, this chapter will establish a framework by which brownfields development can be viewed. Particular emphasis will focus on what opportunities are available to the individual parties at each particular stage of negotiation. It is this lens that we will use to examine the case studies in the next two chapters.

Site Control

One of the first issues encountered in a potential real estate development is how to gain control of a property. Site control is achieved through contracts between the developer and the landowner (e.g., purchase and sale, option to purchase, land lease, etc.) A contract is fundamentally a legally enforceable agreement between two (or more) parties concerning their future actions.¹⁶ All contracts involve three distinct steps. First, there must be an offer. Next, there must be an acceptance. Finally, the basic element of a legally enforceable contract is consideration. Each party must give something of value.

The most common contract used to acquire a piece of property is the purchase and sale agreement (P&S). The P&S serves many purposes. First and foremost, it clearly states the business deal between the buyer and the seller. Second, it provides enough detail as to lower the risk of a misunderstanding. Next, it defines the contingencies, obligations to close, and

what happens if the deal dies. Finally, the purchase and sale agreement sets forth what obligations, if any, will survive the closing.¹⁷

Negotiating the P&S for a site with a history of environmental problems is particularly important. Besides stating the typical aspects of a real estate transaction such as the price and the obligations to close, the P&S for a brownfield site entails many more details. Since signing the P&S will place the buyer within the property's title chain, the buyer must be very diligent during the structuring and negotiating of the contract. This negotiation and the resulting documents will outline which party is responsible for the current remediation work. The document will also define continuing obligations for both the buyer and the seller. In theory, the P&S negotiation allows the investor to negotiate all aspects of the deal before any substantial investment is made. If the investor cannot limit the project's risk to justify the return on investment, the deal will not be undertaken.

Although the P&S is very common, there are many contracts which either replace the P&S or are used before the parties are ready to enter the P&S stage. For example, an option enables an investor to control a piece of property for a period of time without committing to ownership. During this period, the holder of the option can secure financing, obtain tenants or begin the entitlement process. The option holder typically pays a fixed amount of compensation to the property owner and agrees to pay some predetermined amount for the property at the end of the option period. The holder also has the option of walking away from the deal at the end of the option period and may forfeit the option price to the property owner. This strategy allows a developer to eliminate some of the development risk (e.g., financing,

¹⁶ Smith, Douglas. "Note on Contracts," Legal Issues in the Development Process. (Massachusetts Institute of Technology, 1996).

marketing, and permitting) before committing great amounts of resources to the project.

In addition to capping the development risk, an option also serves to protect the investor in the early stages of a project. By avoiding the “chain of title,” the investor can avoid any and all liability associated with the site until the project risks are quantified. There are two ways an investor can avoid being caught in the title chain while the site is contaminated. One way is by utilizing a contract for sale that is conditional upon the seller completing full remediation of the site. A second way is to purchase an option. The option will only be exercised if the seller has remediated the site to the satisfaction of the buyer. In the latter case, the holder of the option should receive back from the seller an agreement to remediate the site.

Another tool available to the developer is a land or ground lease. With a ground lease secured, a developer controls the site for the term of the lease. Typically, the land and all improvements revert back to the landowner at the end of the ground lease. This enables the developer to avoid large outlays of capital at the beginning of project. Instead, the developer will make steady payments to the landowner over the life of the ground lease.

Ground leases are not very common in brownfields transactions. Typically, private parties who want to sell their contaminated sites want to do so as a fee simple transaction.¹⁷ Furthermore, investors are not willing to enter into a deal in which they take all of the remediation risk and the landowner reaps all of the upside at the end of the lease term. However, land leases of formerly contaminated properties do occur between end users and government entities. Connecticut’s Department of Economic Development (DED)

¹⁷ Mack, Robert W. Esq. See generally “Negotiating and Drafting the Purchase and Sale Agreement.”

¹⁸ Fee simple refers to the sale of the land, building and all encumbrances.

categorizes their site cleanups in three groups. One such group, Type III, refers to sites that can be purchased by the state, remediated to acceptable levels, and leased to tenants. The DED uses the lease payments to fund the remediation work.

Government Agencies

The parties involved in brownfields redevelopment will have a great deal of interaction with the federal government (Environmental Protection Agency or EPA) and the state government (usually the Department of Environmental Protection or DEP). Investors in brownfields will most likely be exposed to the Prospective Purchaser Agreement (PPA). This document, which is issued by the EPA, establishes the agreement between the EPA and the investor as to how much site remediation will be required to receive “Covenants Not to Sue” from the federal government. If the site is remediated to the standards requested, the party will receive “Covenants Not to Sue” which cover all future owners and operators of the site.

In dealing with the DEP, an investor may decide to cleanup the site under a state’s voluntary remediation program. As mentioned in Chapter 1, these programs allow any party (e.g., lender, fiduciary, owner, operator, buyer, etc.) to submit environmental site assessments and remediation plans to the DEP for review. Since the level of cleanup required is handled on a case by case basis, there is opportunity for a brownfields investor to negotiate a creative remediation plan. Utilizing the new requirements of the Risk Based Corrective Action program, an investor has some leeway as to what level of remediation is required depending on the site’s future use.

Entitlement Process

In most parts of the world, landowners hold their land subject to regulation by the state. Zoning attempts to cluster uses together and essentially bans certain types of

development from occurring in specific areas. Zoning also regulates the density of proposed real estate developments. However, because virtually all zoning schemes provide for exceptions to the general plan, the developer must be familiar with the local zoning laws and the public approval process. Through this process, the developer can try to obtain a variance, special permit, or zoning change in order to build something other than what is allowed by the “as of right” zoning laws.

Brownfield investors have an opportunity early in a project’s life to work with the local municipality to obtain necessary permits for their proposed project. Many local governments may include the entitlements in a brownfields “initiative” package as an additional incentive to redevelop brownfields. Under this scenario, the investor can lower the project’s risk, shorten the entitlement process, and gain local support before any substantial outlays of capital take place. The decreased risk, time, and opposition should result in improved financial results and an increase in brownfields redevelopment.

Entity Agreement

A real estate investor or developer can take title to a piece of property in a myriad of ways. Some of these options include taking title as an individual, through a partnership, a limited partnership, a limited liability company, a corporation, a trust, or a REIT. Each form has its pros and cons and the developer’s lawyer, accountant and financial planner should all be consulted on this decision. In the context of this thesis, it is the terms of the agreement that matter more so than the form of the entity.

The importance of the entity agreement is that it specifies how much control and liability each party holds in a particular project. In addition, the entity agreement typically spells out how the rewards of a particular project will be parceled out during the life of the

investment. If a deal were structured as a limited partnership, the limited partnership agreement would differentiate between the risks borne by the general partner and those by the limited partners. The agreement would detail how much capital each party has placed at risk and how the party will be rewarded for making the investment.

However, the entity agreement does more than just explain how the risks and rewards will be distributed to the numerous investors. More importantly, the agreement can be used to isolate new capital from the risks of environmental liability. This is vital to the future of brownfields redevelopment. In order to attract sophisticated equity capital, the investment's promoters need to offer their investors high returns and limited liability. At the outset of the project, the participants must decide who will manage the investment and who will have limited management input. It is during the negotiating phase of the entity agreement that these and other vital details will be decided upon.

Financing

“According to the FDIC, loan documents should include language to safeguard lenders against potential environmental losses and liabilities. In light of this guidance, a growing number of lenders insist that they be indemnified by the borrower and any guarantors against liability associated with the collateral.”¹⁹ Unfortunately for the lender, warranties and indemnifications are only as strong as the financial strength of the borrower. Therefore, it is the lender's responsibility to fully understand the risks of a particular project. To do this, the lender should require a “right of access” in the mortgage documents. “The FDIC states that borrowers should be monitored during the life of the loan, as ongoing environmental risk assessments are important to make sure the property used as collateral remains

uncontaminated and retains its value.”²⁰ Monitoring of the property is not considered to be “participating in management” under the Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996.²¹

In addition, lenders are concerned with the ability of the developer to complete the project. Since the redevelopment of an environmentally contaminated property entails many more risks than the development of a pristine site, the lender must be comfortable with the borrower’s ability. This is where a joint venture between a real estate developer and an environmental engineer can add tremendous value.

From the borrower’s perspective, only non-recourse financing is attractive. With non-recourse financing, the lender can only use the specific property to satisfy unpaid debt. The lender has no recourse against the borrower or the borrower’s other assets in case of loan default. This allows the borrower to walk away from projects that are no longer financially feasible. Although non-recourse debt is extremely common in commercial real estate investments, a brownfields lender will be concerned given the nature of the project’s environmental contamination. However, a lender may grant a non-recourse loan if the borrower has a healthy balance sheet and agrees to provide a personal guarantee regarding the remediation of the contamination.

Since sellers of contaminated properties do not have a large pool of buyers at their disposal, they might have to sweeten the offer by providing seller financing. From the buyer’s perspective, the purchase money mortgage will lower their initial required investment, thus

¹⁹ Bartsch, Charles.

²⁰ Ibid.

²¹ Abelson, H. Edward. “Reducing the Liability Risks for Polluted-Property Lenders,” Banker & Tradesman, 30 June 1997, page B13.

improving the project's financial performance.²² Also, if this financing is “packaged” with the purchase of the brownfield, the buyer can avoid spending the time required to obtain financing for the project. A whole layer of risk – financing risk – is eliminated from the beginning. In addition, the seller might understand the level of contamination at the site better than an outside lender would. This would allow the seller to quantify the true risks of the deal easier than an outside lender. However, as with all real estate lending, the risk to the seller is that the buyer could default on the note. Under this scenario, the seller must be willing and able to take back the property and its environmental problems.

By securing a major, investment grade tenant for the project up front, a developer can ease the worries of a lender considerably. The lease will essentially shift the burden of paying debt service from the borrower to the tenant. In addition, the lender has reduced its risk through the strong credit of the pre-leased tenant.

One major problem “with respect to financing remediation and redevelopment of brownfields, [is that] property appraisers in the United States have been generally reluctant to provide valuations of unremediated brownfields. Without property appraisals, lenders are unable to determine a property value for the loan-to-value ratio; therefore, any lending that takes place is usually based on a very low value, requiring more developer equity.”²³ Many real estate investors are lobbying to have appraisals of contaminated properties based on remediated values, even before the remediation begins. That would allow an investor to borrow funds for the acquisition and remediation against the future value of the remediated property.

²² Seller financing is commonly referred to as a purchase money mortgage.

Remediation Contract

The parties involved in the site remediation (e.g., seller, buyer, government agency, environmental engineer, remediation contractor, etc.) have tremendous flexibility during the negotiating and structuring period for the remediation contract. It is during this time that the parties will determine who will bear what risks and who will receive what rewards. For example, a great emphasis during the negotiations will focus on who is responsible for excess cleanup costs, if any. The contract might specify a ceiling on remediation costs thus shifting the risk to the remediation contractor. If the buyer or seller is experienced in the redevelopment of brownfields, the risk of excess cleanup costs might be borne by that party. Every deal is unique and every player brings different skills to the table. One of the primary drivers of the recent joint ventures between real estate investment firms and remediation engineers is to build a team that can understand what environmental risks are inherent in the deal and then price those risks accordingly.

The party that does assume the risk also has the opportunity to purchase an environmental insurance policy that would shift the remediation risk to the policyholder. As mentioned earlier, environmental insurance can play a significant role in the redevelopment and transferability of contaminated properties. These policies can be utilized to lower a project's risk by capping the cost of site remediation. By doing so, a portion of the project's risk is parceled out to another player for a fee. In addition, an investor can purchase a policy that will protect against future liability. It is important to remember that each time a party shifts a certain risk to another, the former must compensate the latter for bearing the additional risk.

²³ Simons, Robert A. and Donald T. Iannone. "Brownfields – Supply and Demand," Urban Land, June

Other variables that can be defined during remediation contract negotiations are the types of performance guarantees that the contractor offers. For example, what constitutes full performance under the contract? Who will determine the project's on-going level of completion? If a problem arises in the future, which party will be responsible to handle the remediation? If the contractor is responsible for future remediation, at what point will this responsibility transfer back to the owner? Since the remediation contract is a vital component of the proposed brownfield redevelopment, the negotiation stage is critical to the project's success.

Leasing/Sale

Leases are used to detail the agreement between the owner and the end user. The major concern of tenants who lease space in formerly contaminated property is one of liability. Will the tenant be responsible for any future remediation work if they are not a "responsible party?" The lease can render the tenant as an operator of the project during the life of its lease if the tenant's actions contributed to site contamination. Since liability under current CERCLA law is applied strict, joint, and several, "operators" can be placed in the path of liability. In response to this, many sophisticated tenants have detailed questionnaires and procedures in place that must be completed before a lease can be signed. There have been cases where an operator protected itself from liability through the substantial due diligence performed prior to signing the lease.

The tenant also wants assurances that its employees will not be harmed. For example, if a site is remediated under the Rebecca Laws, there will still be slight levels of contamination in the ground. Although these contaminants will be contained, the tenant may want to

1997, page 78.

understand what levels and what types of contaminants are still in the ground. This is also helpful if someone attempts to blame the tenant for future problems. The tenant will be able to refer back to the lease or document that described the preexisting condition before the lease began.

The lease also provides the landlord with an opportunity to limit its liability in the future. By placing limits and restrictions on what a tenant can and cannot do on the site, the landlord is proactively attempting to block future environmental problems. The landlord may want personal guarantees from the tenant regarding future environmental contamination. If a company has a strong track record and a healthy credit history, they will have an easier time leasing space than will a start-up company.

Another issue arises when previously contaminated property is sold to an end user (e.g., homeowner). When a land developer remediates a piece of property for a future residential subdivision, there are many issues that must be addressed in the P&S between the land developer and the buyer (e.g., homebuilder, homeowner, etc.) In order to prevent future contamination at the site, a covenant of restrictions might have to be added to the deed. This covenant could be used to prevent certain types of drilling for wells or driving of pylons, as such activities could cause future leeching of controlled contaminants. The end user will also be concerned with future contamination and future third party liability issues. If the site does become contaminated at some time in the future, and the landowner is an innocent party, they will want to understand what rights and remedies they have against the former owner. Furthermore, if contaminants from their site leech into the water supply or onto someone else's property, the homeowner will want to understand their responsibilities and recourse against the former owners. Once again, the parties have many opportunities to address these

issues and many others during the document negotiations.

The cases that follow illustrate a variety of different strategies for addressing each of the above concerns. The first case involves the remediation and redevelopment as a residential subdivision of a former oil tank farm. The second case involves the acquisition of an office portfolio by a REIT. The portfolio included an undeveloped parcel of land that had been contaminated by an adjacent site. Whereas this chapter looks at how the documents work in principal, the case studies will examine how the specific documents work in reality.

CHAPTER 3

Birch Island, Virginia

The true location and participants in this case study have been disguised.

Located on Chesapeake Bay just two miles from Norfolk, Birch Island established its independence from Norfolk in 1992. Serviced by a year-round, state-run commuter ferry service, islanders enjoy all of the benefits of living near a metropolitan area but come home to a relaxed, friendly island setting. The location is surrounded by incredible panoramic ocean views that according to its residents, “cannot be achieved anywhere on the mainland.”

This case study involves a unique oceanfront property that encompasses approximately one-fifth of Birch Island. In addition to a spectacular deepwater coastline, the property contains the largest open meadow and fresh-water pond habitat in the Chesapeake Bay Islands. Twenty-eight residential lots were created on approximately seventy-eight (78) acres, half with direct water frontage. The remaining one hundred (100) acres became an island park and conservation area in perpetuity.

The oceanfront parcels averaged three (3) acres in size with 105’ to 240’ of deepwater frontage. The interior parcels were buildable with more than one-third of them having lovely views toward the Norfolk skyline.

History

In 1944, the United States Navy converted a section of the Island into an oil tank farm that would service naval vessels. The Navy operated this facility from 1944 to 1968 conducting terminal operations for No. 6 fuel oil, diesel oil, and gasoline. This location provided shelter from the rough seas, deepwater piers for the vessels, and reinforced oil tanks that could withstand enemy attacks. A total of fifteen oil tanks were constructed on the island

with a total capacity of over four million gallons. As a federally owned and operated site, the location was exempt from local and state environmental regulation. Unfortunately, like many of the country's military bases, this site was exposed to soil contamination. In 1969, the site was sold to a private oil company, but the new owner did not reactivate the site.

Many years later, the property changed hands again. The new owner, another privately owned oil firm, conducted storage and transfer operations from 1974 until 1981 for No. 2 heating oil and diesel oil. In 1981, the owner decided to remove the site's wooden, deepwater piers and replace them with steel piers. Unfortunately, the company did not obtain necessary demolition and construction permits prior to removing the wooden piers. To its dismay, the local permitting board refused to grant the new permits without the old piers being intact. Having lost the "grandfather" status to build the new piers, the site could no longer serve its original purpose. The facility has been mostly inactive since that time.

Upon removal of the piers, the property's "highest and best use" was no longer as an oil tank farm. Had the property been a pristine "greenfield," most developers would have sought to develop a waterfront residential project. The challenge for the current owner was to find a developer who would understand the intricacies of a brownfield redevelopment and would be willing to purchase this property.

The two cards that the owner held were that the United States government caused the contamination and that the site would be extremely desirable after remediation due to its tremendous oceanfront views. Furthermore, the Army Corp of Engineers ("Federal Government") had already started remediation at the "Federal Areas"²⁴ of the site through its

²⁴ The "Federal Areas" refer to certain portions of the site that the Department of Defense has agreed to assume responsibility and undertake remediation.

Defense and Environmental Restoration Program.²⁵

Voluntary Response Action Program

Although the Federal Government and current owner had been working in conjunction with the state Department of Environmental Protection (DEP) for many years to obtain an Order of Closure²⁶, they were not utilizing the newly enacted voluntary response action program. Like most state voluntary programs, this one allowed any party (e.g., lender, fiduciary, owner, operator, buyer, etc.) to submit environmental site assessments and voluntary response action plans (VRAP) to the DEP for review. Upon approval of the VRAP, the DEP will issue a “No Action Assurance” letter, stating that if the plan is properly implemented, the DEP will assure the parties no enforcement action will be taken.²⁷

Following satisfactory completion of all remediation actions required in the plan, the DEP would issue a “Certificate of Completion,” acknowledging that the applicant has satisfactorily completed the response action. The “Certificate of Completion” included the applicable liability release provisions for either a complete or partial cleanup. The “Certificate of Completion” generally applied to: the party responsible for implementing the cleanup work; successors and assigns of the party implementing the plan; or lenders, fiduciaries and parties providing financing to persons completing the work.

The idea behind the voluntary response action program is that a third party will be granted protection from liability from the government if they: remediated a site to the

²⁵ The Defense and Environmental Restoration Program (DERP) was established by the United States Government to expedite remediation at former military facilities.

²⁶ The “Order of Closure” is a detailed remediation plan approved by the DEP. A closure order is used when underground oil storage facilities are involved.

²⁷ The information regarding the state Voluntary Response Action Program was obtained from a document compiled by the state Department of Environmental Protection. Due to the confidential nature of this case study, the actual state and its DEP will not be mentioned by name.

satisfaction of the DEP; avoided perpetuating the contamination of the site by changing the use; and avoided causing contamination on the site with the new use. For example, if a former gas station is remediated to the satisfaction of the government agencies and the site is converted into a bakery, the new operator should not be held responsible for past contamination. All future liability to the state government remains with the former owner/operators.

Limited Protection

Participants in brownfields redevelopment projects must remember that state voluntary programs do not protect all parties from all risks. For example, the liability protections received through these programs typically do not cover past owner/operators of the site. If a seller is looking to forever be released from liability, the seller may have to “initiate” the remediation process before transfer of the title occurs. Also, the release from liability under these programs is limited to the satisfactory remediation of all known contamination at the time the “Certificate of Completion” was issued. If the environmental engineers and remediation contractors miss levels of contamination, the former owner/operators will not be protected from the liability associated with this newly discovered contaminant.

Furthermore, the program only includes relevant provisions of state law; there is no liability protection granted for applicable federal laws. However, as mentioned earlier, the EPA has stated publicly its intention not to interfere at sites that are participating in state voluntary cleanup programs. In addition, some states have reached a “memorandum of agreement” or “memorandum of understanding” with the EPA. Since they have achieved a level of proficiency in the eyes of the EPA, the EPA honors their “No Further Action” letters at the federal level. This distinction can be vital to whether or not brownfields are

redeveloped, and will be revisited in the final chapter.

American Residential Corporation

Matthew O'Connor, President of American Residential Corporation, first heard about this property through the residents of Birch Island. American had already developed residential subdivisions on Birch Island, and O'Connor realized the huge potential of this site as an oceanfront residential development. If American could understand and be shielded from the environmental risks that this project carried, O'Connor would feel comfortable presenting the investment to American's lenders and investors. Assuming the environmental risks of the deal were mitigated, this project would be similar to other residential land developments that American has completed.

Unlike the seller and the Department of Defense, O'Connor and his team of lawyers and engineers understood the complexities of the voluntary response action program and intended to utilize it for this project. The first problem that American encountered was their weariness toward the prior environmental investigations. O'Connor was not satisfied with the levels of remediation that were required under the proposed Closure Order between the DEP and the seller. American had its engineers conduct additional environmental tests and found higher levels of contamination. All additional discoveries were then added to the scope of the Closure Order. Although the higher scope increased the remediation expense for both the Seller and the Department of Defense, it also lowered the risk of future contamination discoveries for both parties. This was important because both the Seller and the Department of Defense had vast resources that were at risk due to the threat of future discoveries and/or more stringent environmental legislation.

Early discussions with its attorneys provided American with some idea of the issues it

faced in the proposed residential development. Their lawyer identified three main issues:

- “Liability attaches to the owners of underground tanks and associated equipment, not to the owners of real property. To the extent that we can structure the transaction to exclude the tanks, with title taken only to the real estate, accordingly, we can substantially insulate both American and any third party who takes title from any possible liability;
- The DEP’s approval of the closure plan and the work performed under it will be reflected in a letter from them. Either in that letter or in another letter from the DEP we should be able to obtain assurances that the property has been adequately remediated and no further action is required. **Under the recently enacted Voluntary Response Action Plan (VRAP), a prospective purchaser can expressly be relieved of any liability before purchase once a property has been remediated.** Some additional coordination will be required on this, however, since the review of the closure is being handled by a different part of the DEP than the group responsible for the VRAP,²⁸
- **Finally, it would make sense to form an entity that has no assets and exists solely for the purpose of owning the property.** Although this would not be necessary in the event we were able to exclude the tanks from the transfer, should we be unable to do that, use of such an entity should provide some comfort as well.”

Unfortunately, American quickly realized that the seller would not sell the property without including the tank farm. Therefore, American needed to structure the deal so that the proposed residential subdivision would be shielded from the environmental liability that would be attached to the oil tanks. This could be achieved by purchasing the entire property and conveying the tank farm and surrounding area to a separate entity. This entity would maintain the tank farm as a preservation or “Open Space” in perpetuity. Essentially, the contaminated parcel would be remediated and converted into preservation land, and the pristine land would be used for the residential parcels. Furthermore, it was expected that upon completion of remediation work, the open space would be deeded to the Town of Birch Island.

²⁸ The emphasis in this paragraph, as well as those in the remaining pages, was added by the author.

Subsequent Purchaser Problems

Since American would not be the end user of the development, it faced considerable marketing risk in this project. Although it took every precaution when structuring the deal and would ensure that the site was properly remediated, nothing could guarantee a favorable acceptance by the market. If the subsequent purchasers (lot buyers) were unwilling to live within close approximation of a “formerly” contaminated oil tank farm, American’s return on investment could dwindle to unacceptable levels due to sales delays, lower than anticipated lot prices, and unanticipated concession packages.

Over the past decade, the appraisal community has done considerable research in the field of valuation for contaminated property and the effects of continued “stigma” after the site has been remediated. Since value is determined by the end user, user concerns must be translated into tangible costs. When trying to determine the value of a potential brownfields redevelopment, “user concerns are treated as direct costs rather than as factors influencing the cost of capital. For example, if health concerns are associated with the property, users will only be willing to offer a below-market rent. This will then be reflected in the cash flows associated with the property rather than the capitalization rate.”²⁹ American had to fully understand the current residential market of Norfolk and Birch Island in order to determine how the market would receive the newly created lots.

Since American had developed and sold residential lots on Birch Island in the past, it believed that it understood the market. From past experience and studies American knew that the demand for condominiums and clustered homes was very low. At this location, people

²⁹ Chalmers, James and Thomas Jackson. “Risk Factors in the Appraisal of Contaminated Properties,” The Appraisal Journal, January 1996, page 49.

wanted a “piece of the rock.” The buyers would want privacy and shore frontage. American’s biggest constraint was having enough soil for the septic systems. Each lot needed enough “uplands” to support a house, a well, and a septic system. A large percentage of its potential customers were residents of Birch Island, and they understood the levels of contamination better than an outsider would have. However, due to the “stigma” associated with the site, the lots were marketed at a discount. O’Connor estimated that the lots on Birch Island were marketed for approximately thirty percent (30%) below the price of comparable, ocean front product on the islands. It is also interesting to note that these lots could be purchased for about one-third to one-half of the cost of comparable, oceanfront lots on the mainland.

Another subsequent purchaser problem was the risk of future leeching of contaminants onto abutting properties. Although the potential threat of such legal exposure is usually a deal breaker, the future lot buyers in this case would not be liable to the DEP for such contamination under the voluntary program. The Seller would be held accountable. Although the Seller was protected under the VRAP for “known” contaminants that were remediated to the satisfaction of the state, it was not protected from future discovery of contaminants that were not covered under the voluntary program. Recently, additional contamination was discovered on the site and the State has taken a strong position that American and the subsequent owners were not responsible. The State is holding the previous owners accountable for this remediation. The results of this first test of the VRAP on Birch Island are very important. The action taken by the state solidifies the protections offered under the voluntary program.

Purchase and Sale Agreement

American agreed to purchase the entire 176.84-acre site, including the tank farm for three hundred fifty thousand dollars (\$350,000) through the entity American Properties, Inc., a Virginia corporation that was created solely for this transaction. The original intention of the purchase and sale agreement (P&S) was for the property to be divided into two separate parcels: one for the residential subdivision, and one for the open space preservation. One condition that was included in the original P&S was that the open space parcel would be conveyed to a separate buyer at the time of closing. This would allow American Properties, Inc. to avoid ever taking title to the contaminated parcel. At the same time, American would then transfer title of the residential parcel to Birch Island Residential Limited Partnership (BIRLP).

The general partner of BIRLP was American of Birch Island, Inc. (ABI, Inc.) and the limited partner was American Residential Development Fund Limited Partnership (ARDFLP). It was determined from the limited partnership agreement that as general partner, ABI, Inc. would hold a one percent (1%) partnership interest with a one hundred dollar (\$100) capital contribution. In addition, the limited partner, ARDFLP, would hold a ninety nine percent (99%) partnership interest with a two hundred fifty thousand dollar (\$250,000) capital contribution. The thinly capitalized general partner seemed to fit into the framework presented by American's lawyers ("...it would make sense to form an entity that has no assets and exists solely for the purpose of owning the property.")

Some of the "conditions of purchase" in the initial purchase and sale agreement were as follows:

1. "The right to secure approvals from the Town and all other applicable public regulatory agencies for the subdivision of the property;
2. **The Master Plan shall call for the site to be divided into two distinct parcels:**

a “homesite” parcel and a “tank farm parcel;”

3. Soil, wetland, and hazardous materials evaluation studies shall have been performed at Buyer’s expense, with results that are satisfactory to Buyer;
4. Seller shall be in compliance with the Tank Farm closure plan submitted in 1988, approved by the state DEP in 1990, and the property shall not be in recorded violation of any State or Federal environmental regulation. **It is understood and agreed by Buyer and Seller that the remaining required closure of the Tank Farm will be undertaken by the Federal Government and that such closure activities may occur after the closing;”**

The risk in the aforementioned condition was that the Federal Government could fail to perform its remediation duties. If the Federal Government abandoned the project before it was completed, who would be responsible for the cost and performance of final remediation? The agreements between the State DEP and the Department of Defense (DoD) were so specific that American believed there was no way the State could ever force them or the prior owners (oil companies) to perform the work which was the responsibility of the DoD. There was essentially no risk of nonperformance because the Federal Government had contractually agreed to complete the remediation work. However, if a problem did arise, American could not enforce the agreement itself. It had to rely on the DEP to hold the Department of Defense to its contractual obligations.

5. **“It shall be a condition to the obligations of both Buyer and Seller hereunder that the Third Party Properties³⁰ be conveyed by separate direct deed of seller to a grantee or grantees simultaneously with the transfer of the balance of the property to Buyer. Seller shall not be obligated to convey any of the property to Buyer, unless seller is able to convey all of the property, and conversely, Buyer shall not be obligated to accept title to the Third Party Properties;**
6. Buyer shall undertake to identify a grantee or grantees willing to accept title to the Third Party Properties, which may be, at Buyer’s option, any combination of (i) Buyer, (ii) the Town, (iii) an organized conservation trust or entity which regularly takes title to parcels of land for long-term conservation purposes, or (iv) other

³⁰ The “Third Party Properties” include the tank farm, generator building, fire station, and all other improvements located on the “tank farm parcel.”

- responsible entity reasonably acceptable to Seller, willing to accept such title;
7. In addition, **if Buyer is unable to identify grantees of all of the Third Party Properties as provided above, Buyer shall be entitled to elect to terminate this Agreement** by giving notice thereof to Seller, and to receive a refund of the Deposit even if such notice is given after the date which is 90 days after the execution of this Agreement;
 8. **The agreed purchase price for the property is Three Hundred Fifty Thousand Dollars (\$350,000)**, of which (i) \$25,000 has been paid as a deposit upon the execution of this Agreement, (ii) \$325,000 will be paid at the time of the delivery and recording of the Deed.”

First Amendment to Purchase and Sale Agreement

The First Amendment to the Purchase and Sale agreement made the following important changes:

1. “Delete number (4) from above and replace it with...“The Tank Farm Closure Plan submitted in 1988, approved in 1990, shall have been completed, as evidenced by the issuance of a letter from the state DEP, confirming that the Tank Farm Closure Plan has been completed, except for certain monitoring and testing which are required to be continuing in nature, and which may continue past the Closing Date;
2. Seller shall not be obligated to expend more than an aggregate of \$10,000 of Seller’s funds to remove or remediate the materials described [above (e.g., asbestos, petroleum hydrocarbons, etc.)] If the cost to Seller...is more than an aggregate of \$10,000, and if Seller does not elect to expend sums in excess of \$10,000 in order to complete the removal or remediation, then Buyer shall have the right, but not the obligation, to expend sums in excess of those spent by Seller to complete the removal or remediation. If Buyer does not so elect to spend additional sums...then Buyer shall have the option to terminate this Agreement, whereupon the Deposit shall be retained by Seller, and this Agreement shall become null and void and without further recourse to the parties.”

This clause was very important in that it placed a cap on the Seller’s remediation exposure. In addition, the Buyer agreed to assume the cost of remediation for some very specific contaminants in some very specific areas. If the total costs exceeded \$10,000, the Buyer could either expend the necessary sums or terminate the deal. Upon termination, the Seller would retain American’s deposit.

Second Amendment to Purchase and Sale Agreement

Since American was unable to obtain a grantee willing to accept title to the contaminated parcel, it created one that would: American of Virginia, Inc. As of this amendment, the Buyer signed all documents as: “Open Space Buyer – American of Virginia, Inc; Lot Buyer – Birch Island Residential Limited Partnership, by American of Birch Island, Inc., its General Partner.” American still anticipated transferring the open space to the Town of Birch Island upon the completion of all remediation work required under the closure order. The Town would also enjoy all of the liability protections that were associated with the VRAP.

The Second Amendment to the Purchase and Sale agreement made the following important changes:

1. “The agreed purchase price for the property is Three Hundred Fifty Thousand Dollars (\$350,000), of which (i) \$25,000 has been paid as a deposit upon the execution of this Agreement, (ii) \$100,000 will be paid at the time of the delivery and recording of the Deed, (iii) \$160,000 will be paid at the time of the delivery and recording of the Deed by Birch Island Residential Limited Partnership, the “Lot Buyer”, executing a **Promissory Note in the principal amount of \$160,000, secured by a Mortgage, (iv) \$65,000 will be credited to Buyer at the time of the delivery and recording of the Deed as a contribution toward costs Open Space Buyer shall incur in connection with closure activities;**”

With the above addition, the Seller sweetened the deal by crediting the Open Space Buyer (American of Virginia, Inc.) with \$65,000, and by providing a \$160,000 non-recourse purchase money mortgage to the lot buyer (BIRLP). Although American had obtained a commitment from a local lender for non-recourse project financing, it opted to accept the seller financing. O’Connor stated that the local lender would have been comfortable lending the money based on the protections set forth in the state voluntary program.

2. **“At the closing, the Property will be partitioned into two separate portions, and the Purchase Price shall be allocated to those two separate portions as follows: (i) the portion of the Purchase Price allocated to the Open Space Land is \$150,000, including the \$65,000 credit, and the entity that will take title to this portion of the property from the Seller will be American of Virginia, Inc. (the “Open Space Buyer”), (ii) the portion of the Purchase Price allocated to the Parcel Land is \$200,000, and the entity that will take title to this portion of the property will be Birch Island Residential Limited Partnership (the “Lot Buyer”);**
3. **Number (1) from the First Amendment has not been completely fulfilled since certain of the requirements of the DEP for the Closure Plan have not been completed at the date of the closing by the Seller and by the Federal Government...Commencing at the Closing Date, Open Space Buyer shall be responsible to perform all of the requirements in the DEP Closure Order, to the extent not performed as of the Closing Date by the Seller;”**

The \$65,000 credit described above is to cover any costs associated with the remaining requirements under the DEP Closure Order. American had taken on the financial responsibility of completing the remediation plan that was approved by the DEP under the VRAP. At this point, the seller had already spent close to one million dollars (\$1,000,000) and had completed the brunt of the work required. Although the Seller was “on the hook” under CERCLA legislation, it was able to shift the burden of remediation oversight to American.

4. “As required by the DEP Closure Order Conditions for Approval, Open Space Buyer shall be responsible for completing in accordance with the DEP’s approved work plan those closure activities which will be accomplished by the Army Corp of Engineers through its Defense and Environmental Restoration Program. In this regard, Seller shall provide Buyer, and to the extent possible assign to Buyer at Closing, the written contracts and agreements between seller and the Army Corp of Engineers (Department of Defense), outlining the specific responsibilities of the Army Corp of Engineers;
5. As required by the DEP Closure Order Conditions for Approval, to the extent not performed as of the Closing Date, Open Space Buyer shall continue the balance of the two (2) year quarterly ground water monitoring program;
6. As required by the DEP Closure Order Conditions for Approval, in the event that the monitoring and closure activities have not been completed at the time of transfer of any part of the Property acquired by the Open Space Buyer, Open Space Buyer shall state in the sale agreement the responsibilities of each party

relating to the closure and monitoring activities to be completed at the site by Open Space Buyer to ensure the conditions of the DEP Closure Order are met;

7. **In consideration of the \$65,000 credit to be given to Buyer by Seller, Buyer, Lot Buyer, and Open Space Buyer (together the “Purchasing Parties”), and their respective successors and assigns shall (as of the time of Closing) acknowledge their satisfaction with, waive and release Seller from, and assume any of the Seller’s remaining obligations of number (4) from the original agreement and the obligations under the DEP Closure Order which have been assumed by Open Space Buyer. The Purchasing Parties acknowledge that upon the Closing hereunder they shall accept their respective interest in the Property with full knowledge of the contamination identified in the DEP Closure Order, including all plans, reports and test analysis results referenced in that order;”**

With this clause, the Seller contributed \$65,000 to the Buyer for assuming its risk. If the cost of remediation that was required under the DEP was greater than \$65,000, American was responsible for the overage. In addition, although this clause tended to decrease the marketability of the lots, American believed they understood the market well enough to assume the marketing risks of the project. As previously mentioned, a large percentage of their buyers would be Island residents who understood the history and level of contamination that previously existed on the site.

8. **“The Purchasing Parties shall (as of the time of Closing) waive, release and forever discharge Seller, its officers, shareholders, directors, employees and agents and their respective successors and assigns (collectively the “Selling Parties”) from all actions, causes of action, suits, controversies, damages, judgements, claims and demands whatsoever, in law, admiralty or equity, which against the Selling Parties they and their successors and assigns ever had, now have or hereinafter can, shall or may have for, upon or by reason of any matter, cause or thing, but only to the extent relating to the presence of fuel oil, gasoline or any other petroleum products at the Property and only to the extent described in the DEP Closure Order, including all plans, reports and test analysis results referenced in the DEP Closure Order. The provisions of this paragraph shall survive the delivery of the Deed;”**

Note that the above clause did not release the Seller from liability to the government.

This statement only applied to the relationship between the Seller and the Buyer. However,

this did provide the Seller with reassurances that American could not bring action against them in the future.

9. “The Promissory Note in the principal amount of \$160,000, secured by a Mortgage, shall be executed by the Lot Buyer, shall be due and payable two years after the execution thereof, and shall bear fixed interest at a rate at 2% over the Prime Rate at the time of closing, with annual principal payments on the anniversary date of the closing, in the amount of \$80,000 on the first anniversary and \$80,000 on the second anniversary.”

Third Amendment to Purchase and Sale Agreement

The Third Amendment to the Purchase and Sale agreement made the following important changes:

1. “The agreed purchase price for the property is Three Hundred Fifty Thousand Dollars (\$350,000), of which (i) \$25,000 has been paid as a deposit upon the execution of this Agreement, (ii) \$75,000 will be paid at the time of the delivery and recording of the Deed, (iii) **\$120,000 will be paid at the time of the delivery and recording of the Deed by Birch Island Residential Limited Partnership, the “Lot Buyer”, executing a Promissory Note in the principal amount of \$120,000, secured by a Mortgage,** (iv) \$65,000 will be credited to Buyer at the time of the delivery and recording of the Deed as a contribution toward costs Open Space Buyer shall incur in connection with closure activities, (v) **\$65,000 will be credited to Buyer at the time of the delivery and recording of the Deed as a contribution toward costs Open Space Buyer shall incur in connection with defending the Evans appeal of the DEP Closure Order and potential additional closure activities;”**

Based on this additional clause, the Seller credited the Open Space Buyer with an additional sixty-five thousand dollars (\$65,000) to defend the Evans Appeal. Due to the additional credit, the “cash payment” due to Seller at Closing decreased by twenty-five thousand dollars (\$25,000) and the amount of seller financing dropped by forty thousand dollars (\$40,000). The Evans Appeal was based on an appeal filed by Mr. Evans, an abutter to the property. Not satisfied with the underground oil tanks being cleaned and sealed, Mr. Evans insisted that the DEP should require their removal. However, due to the high cost of

collapsing and removing the fifteen oil tanks, the proposal by Mr. Evans was not feasible.

To date, Mr. Evans' appeal has gone as far as the State Supreme Court and has been unsuccessful in every attempt. Since Mr. Evans can take his case to one more court, the U.S. Supreme Court, American used this as an opportunity to effectively lower their purchase price. The \$65,000 will be used to defend an appeal if and when it occurs. American has assumed all of the Seller's risk related to this appeal. If the cost of litigation was greater than \$65,000, American would bear the overage. However, if the expenses associated with this appeal became exceedingly high, American had the ability to terminate the transaction and forfeit its deposit.

Drivers of the Deal

The major catalyst of this deal was the recently enacted Voluntary Response Action Plan (VRAP). As mentioned above, a prospective purchaser can expressly be relieved of government liability before or after a purchase once the property has been remediated to the DEP's satisfaction. In a series of letters from the state DEP to the developer's counsel, the DEP stated:

“The Department of Environmental Protection (hereinafter the “Department”) has reviewed the request of your client for a no action assurance for the subject property. The Department's prior (and continuing) involvement in this site has resulted in a variance request that was filed with the Board of Environmental Protection (BEP).

Provided that the Seller, and their successors and/or assigns, specifically including your client, follow the conditions of the Variance Request and successfully and satisfactorily complete the remedial activities required by said document, the Department will not undertake enforcement actions with respect to the site against the Seller, your client and their successors and/or assigns for conducting these activities.

This no action assurance is restricted to the terms outlined in the Variance Request and may expire without further notice if new information

becomes available indicating that activities at the Tank Facility have caused contamination at the site, including but not limited to ground water in the surrounding area.

Upon satisfactory completion of those activities, the Department shall issue a certificate of completion and the Parties and their successors and/or assigns shall receive the protection from liability afforded by the State's VRAP.

As also indicated in the earlier letter, the Federal Government is also undertaking cleanup action at the Site pursuant to the agreement by the Department of Defense to assume responsibility for and undertake remediation of certain portions of the site (the "Federal Areas.") To the extent new information becomes available indicating that the activities undertaken by the Federal Government have caused contamination at the Site, including but not limited to ground water contamination in the surrounding area, or that further remedial action is required with respect to the Federal Areas, the Department reserves all its rights to seek enforcement and/or other appropriate action against the Federal Government or other appropriate federal entity(ies). **The Department will not take action against the Parties and any of their successors and/or assigns in connection with the Federal Areas."**

Although this letter from the Department of Environmental Protection provided American with limited environmental liability at the state level, it did not provide protection from the Environmental Protection Agency (EPA). In this regard, however, Birch Island is unique. If the EPA decided to push the developer for higher standards of remediation, they would be pursuing another federal agency, the Department of Defense. Had the Department of Defense not been involved in the site's original contamination, an investor/developer would most likely want some assurances from the federal as well as state environmental agencies.

In addition, the second paragraph of the DEP letter provided protection for the Seller under the VRAP. Since the Seller was not a potentially responsible party, it was afforded protections against specific standards of contamination. However, as mentioned earlier, the Seller has been held accountable by the DEP for additional discoveries that were not covered under the voluntary remediation plan.

Financial Drivers

From a risk versus reward perspective, this project was a success. Before the closing, all that American had at risk was the initial deposit of twenty-five thousand dollars (\$25,000). This gave O'Connor the ability to walk away from the deal if the cost of remediation was greater than expected. Once the parties had reached the closing, the financial risk increased. Since American had to deposit an additional seventy-five thousand dollars (\$75,000) at the closing on August 31, 1995, their total investment at risk was now one hundred thousand dollars (\$100,000). In addition, American obtained a loan in the amount of one hundred twenty thousand dollars (\$120,000) from the Seller through the lot buyer, BIRLP. Since the seller financing was non-recourse, American could still walk away from the deal if they were willing to forfeit their one hundred thousand dollar (\$100,000) deposit.

Within six months of the closing, American had sold two of the parcels for an aggregate amount of one hundred twelve thousand five hundred dollars (\$112,500). Since ninety-seven thousand five hundred dollars (\$97,500) of the total was from the sale of a 1.84 acre parcel sold to the Town of Birch Island, one can assume that American was aware of this pending transaction when they closed on the property.

Now that their initial investment had been returned through the two lot sales, the remaining risk was to sell enough lots to pay back the purchase money mortgage and to cover the project's legal and engineering costs. Keep in mind, this was a non-recourse loan, and American had the ability once again to walk away from the deal if they could not successfully market the remaining lots. The other risk at this time was the Evans Appeal. If the legal costs associated with this appeal became exceedingly high, American had the option of defaulting on the note, thus handing the property back to the Seller. American was marketing the various

residential parcels for a total of eight hundred twenty-six thousand dollars (\$826,000.)

Assuming the market was receptive to the offering, American stood to earn a handsome return on its investment.

American was not the only principal to do well in this transaction. The Seller also achieved levels of protection under the state voluntary remediation program and received certain releases from liability with the Buyer. Although the Seller could not eliminate the liability associated with additional discoveries or changes in future legislation, they were protected under state law for the specific remediation actions defined by the approved remediation plan. In addition, they received \$100,000 in cash and \$120,000 in the form of seller financing which would be fully amortized after two years. Overall, this deal was a “win-win” situation for both the Buyer and Seller.

Lessons Learned

The most important reason to conduct thesis research through the case study method is to be able to garner the knowledge that was obtained by the participants in “real deals.” Furthermore, there are always a few pitfalls that can be avoided in the future thanks to the efforts of the daring brownfields pioneers like American Residential Development. Below are some of the major “lessons learned” through the Birch Island project.

American and its team of lawyers and engineers did not accept the level of testing that had been performed by the previous owner and the DEP. The company insisted on conducting its own series of tests and, as a result, raised the required standard of remediation for the site. Since O’Connor believed that American stood to lose the most if the project failed, he insisted on pushing the envelope of the proposed remediation. Essential to this

effort was a highly competent team of legal and environmental professionals. An expert team that is more competent than the state and seller is critical to the success of a project.

According to American's lawyer, some additional coordination was needed to obtain assurances that the property had been adequately remediated and that no further action would be required. This additional legwork was a result of the closure being handled by a different part of the DEP than the group responsible for the Voluntary Response Action Program. The lesson to be learned here is that lots of government agencies are involved in the process of brownfields redevelopment. As such, they can not be relied upon to communicate with each other and within their own offices. Strong legal counsel will recognize this and react accordingly. Going forward, one must wonder if the EPA/DEP can make this process more efficient? This could eliminate many uncertainties and a great deal of risk that in turn could spur increased interest in the redevelopment of brownfields.

When available, real estate investors should obtain non-recourse financing. With this in mind, investors in brownfields have a unique opportunity. Sellers of contaminated properties do not have a large market of buyers available to them. They might have to sweeten the deal to attract serious buyers, and providing non-recourse, seller financing is one such way. From the buyer's perspective, their risk is lowered if they have the option of walking away from the deal. Also, the purchase money mortgage lowers their initial investment. This impacts both their return on investment, and also their total capital at risk in the project.

Despite all of the laws, regulations, and newly enacted brownfields initiatives, a few individuals can cause a project to become financially unfeasible. Unfortunately, brownfield projects tend to affect people on an emotional level. All other things being equal, neighbors

will always want to see every ounce of contamination removed, regardless of cost or feasibility. Given easy access to the judicial system, individuals, like Mr. Evans, can appeal to the courts thus introducing additional cost and uncertainty into the redevelopment process. Unfortunately, there is little that can be done to prevent such lawsuits other than working closely with the community to educate neighbors and abutters about the remediation process. Absent good information, neighbors will usually assume the worse. The smart developer will both work proactively to gain the confidence of the community as well as structure his or her transaction to minimize the consequences of lawsuits that may, in the end, be unavoidable.

CHAPTER 4

Main Street Office Park

History³¹

While completing the due diligence phase for the acquisition of a portfolio of properties, a prominent real estate investment trust (REIT) discovered environmental contamination affecting the only undeveloped parcel in the portfolio (the “Main Street Site.”) Located in a strong, suburban office market, the portfolio consisted of prime office properties and the undeveloped parcel. Elevated levels of a contaminant called trichloroethene³² (TCE) were found in the groundwater near the border of an adjacent automobile garage (the “Source Site.”)

Subsequent environmental testing showed relatively high concentrations of TCE on the Main Street Site and an extremely high level on the Source Site. While it could not be conclusively ascertained, it is most probable that the Source Site was (and is) the source of the TCE contamination on the Main Street Site. Since the direction of the groundwater flow at the Source Site was mostly away from the Main Street Site, it was assumed that the migration of the TCE via groundwater most likely had occurred over a number of years (15+). It was impractical, therefore, to simply remediate the Main Street Site without having the Source Site also undergo remediation work.

Further complicating matters was the fact that the Source Site was owned and controlled by a family trust (the “Source Owners.”) While the Source Owners were cooperative, they would most likely not have the financial resources necessary to undertake

³¹ Information on history of site provided in Environmental Briefing authored by REIT’s senior acquisitions analyst.

³² TCE is a solvent used in de-greasing processes and is a known carcinogen.

the scope of the required remediation work. In addition, the regulatory agencies and rules that governed this type of remediation work (primarily the State Department of Environmental Quality, or “DEQ”) were bureaucratic and complex.

Three sets of principals (e.g., Seller, Buyer, and Source Owner), their legal counsel and their environmental consultants worked together to understand the laws and the implications associated with the environmental issues at these properties. A thorough understanding of the issues, laws, and future course of remediation, along with a negotiated agreement between the Buyer and the Seller, were the components that allowed the REIT to close on the purchase of the portfolio in a relatively short period of time (approximately one year). Among other provisions, the negotiated agreements called for the seller to escrow part of the sales proceeds to be applied toward future remediation costs. As will be discussed later, this was very important to the transaction because the buyer had “deeper pockets” than the seller.

The REIT acquired the portfolio for an undisclosed amount of consideration consisting of assumption of mortgage debt and the issuance of Operating Partnership Units (“OP Units.”) According to the REIT’s Annual Report, “each OP Unit may be redeemed for either one share of common stock or, at the option of the Company, cash equal to the fair market value of a share of common stock at the time of the redemption.” REIT transactions are frequently structured in this manner so that the seller of appreciated property does not have to recognize taxable gain at the time of receipt of the OP Units. Gain is recognized only at the time the OP Units are converted to cash or stock.

OP Unit Pricing

Although “time is of the essence” in most all real estate transactions, this is especially

true if the transaction involves a “capital play.” In this particular transaction, the Seller was swapping property (e.g. office buildings and undeveloped land) to a publicly traded real estate investment trust in exchange for operating partnership units that are the functional equivalent of stock in the REIT. During this period, the REIT’s price per share of common stock was increasing rapidly and outperforming all of the major market indices.

One of the major risks to the Seller was that they would receive fewer Units at closing due to the rising market. The acquisition price was fixed in dollars from the beginning and the only variable was the “average of the closing prices of the common stock of the Buyer for each trading day that occurred during the thirty consecutive calendar days commencing the date of this Agreement.” The higher the “average price” was, the fewer OP Units for the Seller at closing. With all of this in mind, the Seller should have known it was in its best interest to consummate this transaction as quickly as possible. Although not directly a brownfields issue, the motivation of the Seller to complete the deal in a short timeframe may have resulted in the buyer having a stronger negotiating position regarding the brownfields issues. However, this is purely speculative for two reasons. First, none of the other case studies utilized for this research involved a REIT. Second, the acquisitions team from the REIT stated that the Seller never mentioned the rapidly increasing OP Unit value.

Option Agreement

As stated in Chapter 2, an option enables an investor to control a piece of property for a period of time without committing to ownership. During this period, the holder of the option can secure financing, obtain tenants or begin the entitlement process. The holder can also walk away from the deal at the end of the option period, thus forfeiting the option price. This strategy allows a developer to eliminate some of the development risk (e.g., financing,

marketing, and permitting) before committing great amounts of resources to the project. In addition to capping the development risk, an option also serves to protect the investor in the early stages of a project. By avoiding the “chain of title,” the investor can avoid any and all liability associated with the site until the project risks are quantified.

However, the above reasons were not the motivating factors behind the REIT’s choice of using an option agreement for this acquisition. Its sole intent was to carve out a period of due diligence, during which it could fully understand the contamination issues. Whereas most option agreements grant the holder a long period of time to conduct due diligence and begin the entitlement process, this agreement only allowed for a thirty to sixty-day period.

However, every amendment to the original agreement extended the investigation period even further. These extensions represented an opportunity cost to the Seller; nonetheless, they were needed to allow the REIT to get comfortable with the environmental issues. According to the Buyer, “even though this agreement was in the form of an option, it was no better or worse than a purchase and sale agreement.”

Some of the relevant components of the initial agreement were as follows:

1. Grant and Exercise of Option: The Option may be exercised by Buyer’s giving written notice of Buyer’s exercise to Seller within the period commencing on the thirtieth (30th) day from the date of this Agreement and ending on the sixtieth (60th) day from the date of this Agreement;
2. Deposit: Simultaneously with the execution and delivery of this Agreement, Buyer shall deliver...\$500,000 to be held in escrow;
3. Grant and Exercise of Option: The notice of exercise of the Option by Buyer shall be accompanied by, and the effective exercise of the Option shall be conditioned upon, delivery...of \$1,500,000 to be held in escrow. The notice of exercise of Option shall also set the Closing Date, not less than thirty (30) days nor more than sixty (60) days after the date such notice is given;

The REIT paid \$500,000 in cash to the Seller to obtain the initial option agreement.

This deposit was fully refundable upon termination of the agreement. It was not at risk until the Buyer exercised the option, at which time an additional \$1,500,000 would be placed in an escrow account.

4. **Termination: Buyer shall have the right, in its sole discretion, to terminate this Agreement at any time on or before the Option Exercise Date.** Upon any such termination, the Deposit shall immediately be refunded to Buyer, and...the rights and obligations of each of the parties to this Agreement shall cease and terminate and none of such parties shall have further liability under this Agreement;”

With this clause, the Buyer had the ability to walk away from the deal before the Option Exercise Date. The total amount of the Buyer’s refundable deposit was \$500,000. In addition, this clause gave the Buyer the ability to get a better understanding of the level of contamination on the site before it put any large sums of capital at risk (e.g. \$2 million).

5. **Tests and Inspections: Seller hereby authorizes Buyer...to enter upon the Premises from time to time and to perform such tests and inspections as Buyer deems necessary** or appropriate in its sole discretion, including, without limitation, such soil boring and compacting tests, test well and water table, soil porosity and liquid absorption tests, other environmental inspections and tests, and engineering tests. All expenses for such tests, inspections and restoration shall be the responsibility of the Buyer;
6. **Environmental, Health and Safety Matters – Representations and Warranties: Each Seller hereby represents and warrants as follows, but only with respect to its portion of the Premises:**
 - i. **To the best of Seller’s knowledge...**there have been no releases, including, without limitation, migrations of hazardous materials or any other substances or materials regulated under any Environmental Law (collectively, “Hazardous Materials”) at, on, under, onto, about or emanating from Seller’s portion of the Premises during its period of ownership, and to the best of Seller’s knowledge, there has been no such release at any other time;
 - ii. Seller has been issued, and Seller is in material compliance with, all orders, directives, requirements, certificates and Permits from applicable governmental authorities relating to Environmental Laws applicable to Seller’s portion of the Premises;
 - iii. Neither Seller’s portion of the Premises nor any portion thereof is listed or, to the best of Seller’s knowledge, proposed for listing on the National

Priorities List pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act, as amended (“CERCLA”) or on any state list of sites requiring remedial action;”

The above statement, “[t]o the best of Seller’s knowledge...,” had serious legal ramifications. The Seller was only giving representations and warranties regarding contamination that were known to them. Therefore, any contaminants that were discovered through testing by the Buyer were not covered under this statement if the Seller was unaware of them. However, under the Agreement, the Buyer was required to share all “knowledge” and discoveries with the Seller. This was a very important fact. If the Buyer told the Seller about a recently found plume of contamination, the Seller was now considered to be “aware” of the contamination. This contamination would then be “covered” under the representations and warranties clause of any future amendments. With this in mind, the Buyer had to conduct its own series of tests. It could not rely upon the Seller’s knowledge.

Another concern to the Buyer was the statement: “[e]ach Seller hereby represents and warrants as follows, but only with respect to its portion of the Premises.” A major risk inherent in this transaction was that the “Seller” actually consisted of many limited partnerships. Each one was giving “representations and warranties” on its portion of the Premises only. What if some sellers were better capitalized than others were? What happened if one seller got into financial distress? Would they dissolve their limited partnerships after the sale? The Buyer handled this issue in the forthcoming Fifth Amendment to the Option Agreement by requiring the Seller to set aside proceeds from the sale into an escrow account for remediation expenses.

7. “Miscellaneous: All representations and warranties of Seller shall survive the Closing Date for a period of twelve (12) months, other than those contained in [numbers (6.i. - iii.) above.] **Seller shall have no liability for any**

misrepresentation with respect to which a claim is made by Buyer after such twelve (12) month period;”

Since the REIT would place itself in the title chain before the twelve-month period expired, it would be exposed to the unlimited liability of an owner anyway. However, the REIT intended to limit this liability in the future by remediating or causing the Seller to remediate the site under the state voluntary remediation program. Also, since the REIT had “deeper pockets” than the Seller did, it would be responsible for the majority of future liability (e.g., future discoveries, stricter legislation, etc.)

Third Amendment to Option Agreement

The Third Amendment to the Option Agreement made the following important changes:

1. **“Termination:** [The following was added to the original clause:] **Buyer shall have the right, in its sole discretion, to terminate this Agreement by written notice to Seller at any time on or before the date which is thirty (30) days following the date of the Third Amendment (the “Remediation Plan Approval Date”) if Buyer is not satisfied, in its sole discretion, with the environmental condition of the Premises, the Remediation Plan, any proposed arrangement for the escrow and disbursement of funds or other security therefore, as requested by Buyer in its sole discretion, the implementation of any such proposed remediation plan or any matters relating to any of the foregoing;”**

This clause was used to grant to the Buyer an extension of its due diligence period.

Up to this point, the Buyer had deposited \$500,000 with the original Agreement, which was fully refundable. However, many hours of time, as well as legal and environmental expenses, had been invested. Although the Buyer would receive back its initial deposit upon termination, the time spent thus far was considered a “sunk cost.” With this in mind, the Buyer had to reevaluate the deal with regard to risk and return at every stage. This clause gave it the ability to extend their period of investigation before it needed to place \$2,000,000 at risk.

2. **“As-Is Acquisition: Buyer agrees to accept the Premises “AS IS”, “WHERE IS” and “WITH ALL FAULTS” in its condition as of the Option Exercise Date, subject to Seller’s obligations under the Remediation Plan, ordinary wear and tear during the Interim Period, and the representations and warranties made in this Agreement.”**

Although the Buyer agreed to purchase the Premises on an “AS IS” basis, the Seller would still be held accountable for its obligations under a remediation plan (the “Remediation Plan”) that needed approval from the state DEQ and the REIT. Since there was no monetary cap on the Seller’s obligation to remediate the site, it assumed all of the financial risks of the remediation. The Buyer’s risk was that the Seller would not perform the remediation, or they would perform it incorrectly. If there were problems in the future, which party would be held accountable to cure it? All of these issues would be hashed out in the Fifth Amendment to the Option Agreement.

Fifth Amendment to the Option Agreement

Beginning with the First Amendment to the Option Agreement, the documents referred to “Buyer” and “Main Street Site Owner.” Buyer referred to the REIT that would purchase the portfolio of office buildings, and Main Street Site Owner referred to the entity that would purchase the contaminated, undeveloped parcel of land (the Main Street Site). This distinction allowed the REIT to purchase the contaminated site through a different entity if it so desired.

In the end, the REIT chose to acquire the entire portfolio through its existing entity. Although another entity could have been established to acquire the contaminated parcel, the Buyer knew it would be recognized as a shell, and, as such, would not limit their liability. Furthermore, it felt comfortable with the escrow balance that was established at Closing. Since the REIT chose not to purchase the Main Street Site through a different entity, the terms

“Buyer” and “Main Street Site Owner” will be modified to “Buyer” throughout the rest of this chapter.

The Fifth Amendment to the Option Agreement outlined the arrangements that were negotiated to handle the environmental issues affecting the Main Street Site. These contractual arrangements included:

1. **“Establishment of Escrow: Upon closing...OP Units [valued at \$1 million]...will be delivered to the Title Insurer to be held in escrow pursuant to the terms of an escrow agreement;”**

As mentioned earlier, the Buyer was concerned that the Seller was actually a collection of numerous limited partnerships. Fearing that the limited partnerships would dissolve after the Closing, an escrow account was established to cover remediation expenses. The Seller was not the only participant with a capital market risk inherent in this transaction. The Buyer’s risk was that the escrow balance, which was based on OP Unit value, would decline if the share price of the REIT declined. If the value of the OP Units were rising, the Seller could swap the Units out for cash and capitalize on the arbitrage opportunity. However, if the value of the Units were decreasing, the Seller would have to fund the deficit. The Buyer was assuming the credit risk of the Seller. If the escrow balance decreased in value, would the Seller be willing and able to rectify the shortage?

Just as important as the creation of the escrow funds was the establishment of a “cap” on the Seller’s financial liability. The first clause of the Fifth Agreement essentially “capped” the Seller’s liability for the site remediation at \$1 million. Any remediation expense that fell under the requirements of the Remediation Plan and was over and above the \$1 million level would be borne by the REIT.

The “uncapped” liability of site remediation that now fell under the responsibility of the Buyer could have presented a major concern to the shareholders of the REIT. However, the Buyer was only responsible for the remediation levels that were required under the DEQ approved Remediation Plan. Furthermore, if the Buyer deemed the Remediation Plan to be too costly, it could terminate the deal on that basis. According to the REIT’s Annual Report:

“In connection with the acquisition of the [Main Street Site], the sellers have reported the findings of contamination to the [State] Department of Environmental Quality and have retained an environmental consultant to prepare a remediation plan. Units valued at approximately \$1.0 million were escrowed from the purchase price to be released to the seller upon performance of remediation pursuant to a remediation plan approved by the Company. The escrow further provides that the Company may receive some or all of the remaining escrowed Units upon certain conditions. The Company does not believe that any costs, if incurred, in connection with these environmental matters would have a material adverse effect on the financial position, results of operations, or liquidity of the Company.”³³

Based on the following clause, the Seller had to seek agreements from the owners of the Source Site that would give the Seller access to the Source Site for remediation or that obligated the Source Site owners to perform the remediation themselves.

2. “Arrangements with Adjacent Property Owner: Seller agrees to seek promptly and to pursue diligently, continuously and in good faith the entry into agreement(s) (collectively, once approved by [Buyer] as provided below in this Section, the “Source Site Remediation Agreements”) with the owner of the site adjacent to the Main Street Site. **The Source Site Remediation Agreements shall provide Seller with access to the Source Site to perform or cause to be performed remediation of contamination thereon or contain the agreement of the owner of the Source Site and its successors and assigns to perform remediation of contamination on the Source Site,** in each case pursuant to the Remediation Plan (as defined below). The Source Site Remediation Agreements shall be in form and substance reasonably satisfactory to Seller, the owner of the Source Site and Buyer, including, without limitation, by containing provisions which cause such Agreements to be binding on successor of the Source Site, and **the interest of Seller therein shall be fully assignable to [Buyer]** (and its successors and

³³ The identity of the REIT will remain unnamed.

assigns) without the consent of the owner of the Source Site. Except as otherwise set forth in this Agreement, **Seller shall have no liability for failure to obtain the Source Site Remediation Agreements;**”

A major risk to the Seller and the Buyer was that the Source Site testing that would be performed could have exacerbated the contamination. In order to avoid this risk, both the Buyer and the Seller used insured, third party environmental engineering firms. Thus, the risk of aggravating the contamination could be managed by hiring competent engineering firms.

However, an even greater risk of the above clause was that the Seller might not get the necessary approvals from the Source Site Owner. If this happened, the Buyer could terminate the deal before the Option was exercised. If the Buyer chose to exercise the Option prior to the Seller obtaining the Source Site Remediation Agreements, it would place itself in a riskier position.

In fact, the Buyer did acquire the portfolio before the Remediation Agreements were obtained. They felt comfortable about this assumption of risk for two reasons. First, the escrowed funds of \$1 million would likely cover the remediation costs of both the Source Site and the Main Street Site. Second, if the Seller could not obtain the Source Site Remediation Agreements by the fifth anniversary of this Amendment or if the Seller had dissolved, the Buyer would receive the remaining escrow balance. Furthermore, the Buyer did not have to remediate the site under the voluntary program; it could remediate the site under the current state and federal regulations. However, as described in the next section, the voluntary program offers the advantage of providing finite closure certification upon completion of the remediation.

From the Seller’s perspective, if it never obtained the proper approvals, it would still

have the OP Units from the closing proceeds. The Seller's only loss would be the potential balance left in the escrow account.

According to the Amendment, once the Seller had obtained the Source Site Remediation Agreements, it had to obtain approvals for a remediation plan covering the Source Site and the Main Street Site from the State DEQ.

3. **“Obtaining of DEQ Approval by Seller: Promptly upon obtaining the Source Site Remediation Agreements, Seller shall take or cause to be taken all reasonable actions necessary to obtain, and shall diligently, continuously and in good faith seek to obtain, the approval of the State Department of Environmental Quality (the “DEQ) (such approval, “DEQ Approval”) and [Buyer] of a remediation plan for the Source Site and Main Street Site. Such remediation plan, as approved by Seller, the owner of the Source Site, DEQ and [Buyer] shall comply at all times with all applicable Laws, including, without limitation, all requirements of governmental authorities and shall be hereinafter referred to...as the “Remediation Plan.” Nothing herein contained shall require the [Buyer] to approve a Remediation Plan if such plan is not under the Voluntary Remediation Program (the “VRP”) and nothing herein contained shall require Seller to enter the VRP; provided, however, that the Remediation Plan proposed to the owner of the Source Site shall require the Remediation Plan to be under the VRP;”**

The Remediation Plan was subject to the reasonable approval of the Buyer and the Buyer had no obligation to approve any plan that was not under the State Voluntary Remediation Program (VRP). The VRP had the advantage of providing finite closure certification upon completion of the remediation and helped to protect the registered owner(s) from any interim litigation, citations, or claims. The following is a description of the VRP from the state DEQ:

“When the cleanup is satisfactorily completed, DEQ will issue a "certification of satisfactory completion of remediation." This certification provides assurance that, barring new data that contradict the decision, the remediated site will not later become the subject of a DEQ enforcement action.

It is anticipated that the Voluntary Remediation Program will

facilitate the sale and reuse of industrial and commercial properties. By reusing developed properties, not only are economic benefits expected both for the seller and the buyer, but also the trend toward expansion of commercial sites onto pristine lands should decrease as the potential environmental liabilities of developing on existing commercial properties is diminished.

By overseeing the process, DEQ is able to ensure that the cleanup achieves a satisfactory level of human health and environmental protection. **The program is not intended to serve as an alternative to, or refuge from applicable laws, regulatory requirements, or enforcement actions.”**

The alternative to the VRP program was a negotiated remediation standard and plan with the applicable regulatory agencies; an open-ended closure certificate would be issued upon completion of the remediation plan work that would allow the regulatory agencies to make additional citations and claims against the same site and work.

As mentioned in Chapter 3, participants in brownfields redevelopment projects must remember that state voluntary programs do not protect all parties from all risks. For example, the liability protections received through these programs typically do not cover past owner/operators of the site. If a seller is looking to forever be released from liability from the state government, the seller may have to “initiate” the remediation process before transfer of the title occurs. Also, the program only includes relevant provisions of state law; there is no liability protection granted for applicable federal laws. Furthermore, the release from liability under these programs is limited to the satisfactory remediation of all known contamination at the time the “Certificate of Completion” was issued. This point was covered in the VRP description:

“The immunity granted by issuance of the Certificate shall be limited to site conditions at the time of issuance as those conditions are described in the information submitted by the Participant pursuant to participation in the program and is conditioned upon completeness and

accuracy of that information. The immunity does not apply in the event that contamination posing an unacceptable risk to public health or the environment is discovered after issuance of the Certificate.”

Once a remediation plan was finalized, the Seller had to either remediate or cause the Source Site owner to remediate, whichever was required under the Source Site remediation agreements that the Seller was able to obtain. As stated in the following clause, the Seller was not required to spend more than the escrow balance of \$1,000,000 in remediating the Main Street Site and in remediating or causing the remediation of the Source Site.

4. “Performance of Remediation: Promptly upon finalization of the Remediation Plan, Seller shall commence or cause to be commenced and shall diligently, continuously (subject to delays caused by events beyond the reasonable control of Seller) and in good faith perform or cause to be performed to completion remediation of the Source Site and Main Street Site in accordance with the Remediation Plan and the Source Site Remediation Agreements. Seller shall require all parties performing remediation on the Main Street Site to maintain insurance providing coverage of the types and amounts and naming the [Buyer]. **Seller shall diligently, continuously and in good faith seek from DEQ upon completion of remediation in accordance with the Remediation Plan a Certificate of Satisfactory Completion Remediation from the DEQ.** Seller shall not be obligated to expend more than [the escrow balance of \$1,000,000];”
5. “Assignment of Source Site Remediation Agreements to [Buyer]: Upon the default by Seller in the performance of any of its obligations under the Agreement...or in the event the Seller fails to obtain the DEQ Approval by the fifth (5th) anniversary of the date of this Amendment...then...**Seller shall assign to [Buyer] its rights under the Source Site Remediation Agreements;**”

The Buyer had to be ready and able to assume full responsibility for the remediation process at any time. If the above clause went into effect, all remediation problems would fall under the responsibility of the REIT. However, the REIT would assume this risk when it placed itself in the “chain of title.” Since the Buyer had “deeper pockets” than the Seller did, it was completely exposed to any risk that was associated with the project once it enter the title chain.

6. Delivery of Assets in Escrow to [Buyer] on the Occurrence of Certain Events: If (i) the [Buyer] is ever required by Law...to perform any remediation on the Main Street Site or Source Site other than as provided for in the Remediation Plan, (ii) a lease is entered into for space in a building to be constructed on the Main Street Site, or (iii) in the reasonable judgement of the [Buyer], a failure to act could result in a claim against such owner on account of a change in the environmental condition of Main Street Site or any matter resulting therefrom occurring subsequent to the Closing Date, Seller shall cease to be entitled to [OP Units] and Substitute Cash held in Escrow;”

The aforementioned clause added some flexibility to the Buyer. If the Buyer required, the Seller had to perform remediation work beyond that which was specified in the approved plan on the Source Site and/or Main Street Site as long as the Seller’s financial burden did not surpass the \$1,000,000. The Buyer also had the right to perform the additional remediation itself and receive reimbursement up to the remaining balance of the Escrow account if (1.) any new law required remediation work; (2.) a lease was executed with a tenant for space in a building to be constructed on the Main Street Site; or (3.) if Buyer felt remediation on the Main Street Site was necessary to prevent the Buyer from environmental exposure liability to a third party.

Since the REIT planned to develop the parcel when market rents justified new construction, it would require construction financing. Although it could tap into unsecured debt balances for this need, it preferred to use conventional construction financing. This clause gave the REIT control over the remediation process. Without this level of control, most lenders would have a difficult time underwriting the loan.

7. “Delivery of Assets in Escrow to [Buyer] Upon Failure to Obtain Certain Approvals: **If, on or before the fifth (5th) anniversary of the date of this Amendment, Seller has not...obtained the Source Site Remediation Agreements and DEQ Approval, Seller shall cease to be entitled to any [OP Units] and Substitute Cash held in Escrow, and [Buyer] shall be entitled to receipt of [OP Units] and Substitute Cash being held in the Escrow equal in value in the aggregate to the reasonable costs of remediation;**

8. Delivery of Assets in Escrow to [Buyer] for Failure to Obtain Closure Certification: Except as provided below in this Section, **if Seller has not obtained the Closure Certifications on or before the fifth (5th) anniversary of the date of the DEQ Approval...Seller shall cease to be entitled to any [OP Units] and Substitute Cash held in Escrow, and [Buyer] shall be entitled to receipt of [OP Units] and Substitute Cash being held in the Escrow equal in value in the aggregate to the reasonable costs of remediation;**
9. Delivery of Remaining Assets in Escrow to Seller on Receipt of Closure Certifications: **Upon receipt by [Buyer] of the Closure Certifications... Seller shall become entitled to...any remaining OP Units...and Substitute Cash then remaining in the Escrow;”**

The above three clauses stipulated whether or not the Seller would receive any of the remaining Escrow balance. The Seller would not be entitled to the balance remaining in the escrow account if (1.) the Seller defaulted; (2.) the Seller failed to obtain the requisite remediation agreements from the Source Site owners within five years from the date of the Fifth Amendment; (3.) the Seller failed to obtain the necessary DEQ approval of a remediation plan within five years from the date of the Fifth Amendment; or (4.) the Seller failed to obtain the remediation closure certifications from the DEQ within five years of obtaining the DEQ’s approval of the remediation plan. In establishing these clauses, the REIT attempted to align the Seller’s interest with their own by establishing a monetary incentive for performance.

There are two risks for the Buyer with the above clauses. First, it must be ready and able to take control of the process if the Seller fails. This necessitates that the Buyer and Seller must continuously update each other as to the status of each requirement. Next, there is a risk that neither party will be able to obtain the required approval from the state DEQ. Under this scenario the REIT has entered the title chain, but has no way of limiting its liability through the state voluntary program. It is essential that the Buyer understands the levels of contamination before exercising its option.

10. “Retention of Rights against Owner of Source Site: The parties hereto agree that Seller...and [Buyer] shall retain all of their rights in law and in equity against the owner of the Source Site.”

Very little focus has been placed on the Source Site Owner’s responsibility to remediate the Source Site. Due to their financial difficulties, all parties assumed that the remediation work would have to be performed by the Seller and Buyer of the Main Street Site. However, in the minute chance that the Source Site Owner could reimburse the parties that remediated the site, this clause provided for the Seller to get fully reimbursed before the Buyer did.

It is interesting to note that neither the Buyer nor the Seller was a “potentially responsible party.” However, assuming this transaction closed, the Buyer would join the Seller in the title chain. Could these parties be held accountable for any future leeching from the Source Site? If the Main Street Site contamination leeches onto abutting properties, which party would be liable? According to the DEQ, under the VRP:

“The Participant reserves the right to seek contribution, indemnity, or any other available remedy against any person other than the Department found to be responsible or liable for contributions, indemnity, or otherwise for any amounts which have been or will be expended by the Participant in connection with the Site.”

The REIT will not be held accountable for remediation activities at the Main Street Site if they fall under the scope of the approved Remediation Plan. However, if additional contaminants leech onto the Main Street Site from the Source Site or if contaminants from the Main Street Site leech onto abutting parcels, then the REIT will be held responsible for the remediation expenses. Even though they can pursue the Source Site Owners for damages, the family trust will most likely not have the

resources necessary to cover such damages.

11. “Limitation on Seller’s Liability: Except as provided in [number 6 above], **Buyer...hereby waive[s] any and all rights at law and in equity against Seller on account of the existence of the contamination disclosed in the Seller’s Environmental Reports, including, without limitation, any claim for diminution in value of Main Street Site on account thereof.** Notwithstanding the above, nothing in this Agreement shall be construed to limit any of Buyer’s...rights at law or in equity for contribution or any similar right in the event either of them incurs any liability to a third party on account of facts or circumstances existing on or before the Closing Date with respect to the environmental condition of the Main Street Site or the Source Site. For the purpose of the immediately preceding sentence, “third party” shall not be deemed to include any governmental agency;
12. Assignment: **Buyer...shall have the right to assign all or any portion of their interests in the Agreement to any subsequent owner or occupant of all or any portion of the Main Street Site or any lender and, at Buyer’s election, Seller shall convey title to Main Street Site on the Closing Date to an entity elected by Buyer.”**

Financial Drivers

Knowing nothing about the Seller’s original investment in the portfolio, its true reward from this deal had to be the tremendous return that the OP Units generated post closing. In addition to receiving fair market value for an environmentally challenged site³⁴, the Seller also postponed having to pay capital gains tax. A taxable event will not occur until the Seller redeems OP Units for stock, and then sells the stock. In addition, the Seller was relieved of some environmental liabilities. Except for the funds in the escrow account, the Seller has shifted all of its liability associated with the site to the REIT. Like the REIT, the Seller is not a “potentially responsible party.” They did not cause the contamination; the Source Site Owners did. Finally, if the Seller remediates the site and receives the DEQ approval, they will

³⁴ The sale price was equal to that of an uncontaminated site minus the escrow funds. However, under certain conditions, the Seller could receive back a portion of the remaining escrow balance.

be entitled to additional escrow funds that were in excess of the remediation costs.

From the Buyer's perspective, it was acquiring a portfolio of well performing office buildings and a parcel of land that, due to its location, had tremendous potential for future development. The REIT was willing to enter this transaction due to the strength of the properties and the local real estate market where the site is located. Also, as stated, the potential upside of the undeveloped parcel, due to its location, was enormous.

The REIT assumed all of the marketing risk for the redevelopment of the site. It could mitigate this risk by avoiding speculative construction. By participating in a build-to-suit project or by pre-leasing the building, the REIT could lessen the risk that a tenant will not pay "market rent" for the space. However, since the REIT will build an office building and structured parking on the site someday, they can use either or both of the structures to "cap" the remaining contamination.

In conclusion, the protection provided by the strong language of the State's Voluntary Remediation Program helped the REIT quantify its liability and price the transaction accordingly. The REIT is only responsible for the scope of remediation work required under the "approved remediation plan." If there are contamination problems in the future, the state will have to prosecute the Source Site Owner (if possible) or use government funding to remediate the Source Site and the Main Street Site.

Lessons Learned

This case study offers many lessons that are different from the Birch Island case. The major differences stem from the buyer's form of entity and the product type. Unlike American Residential Development, this case study involves a buyer that is a publicly traded real estate investment trust. Also, unlike the residential land development that occurred on

Birch Island, this project involved prime office properties and a parcel of land suitable for future development. Below are some of the major “lessons learned” through the Main Street Site acquisition.

From the very first conversation with the Seller, the REIT stated that it had no intention of using the contamination issue to lower the purchase price during ongoing negotiations. Once the purchase price was established and agreed upon by both parties, it would remain fixed. The REIT strongly believed this was the only way to earn the “trust” of the Seller and build a strong relationship. In a transaction that involves contamination issues, parties begin to question the true goals of their counterparts. By sticking to its promises, the REIT gained the Seller’s complete trust.

The issue of trust went beyond the fixed transaction price. Since there are very few “black and white” answers during a brownfields project, the parties had to work on a cooperative strategy throughout the deal. If there were a lack of trust among the parties, each side would have questioned the other side at every stage of negotiations. For example, all of the documents that were negotiated hinged on one specific clause--the control of the escrow funds were at the “Buyer’s discretion.” The REIT was able to forge a strong relationship with the Seller by not exercising its right to take over the escrow account and the remediation process from the start.

As mentioned throughout the case study, one of the major risks to the Seller was that the consideration or total number of Units was decreasing due to the rising market. The higher the “average price” was, the fewer OP Units for the Seller at closing. With all of this in mind, the Seller should have been aware that it was in its best interest to consummate this transaction as quickly as possible. Although not directly a brownfields issue, the motivation of a seller to

conduct a transaction with a REIT in a short timeframe could provide the REIT with tremendous leverage while negotiating the brownfields issues.

Also, the fact that the Seller was actually a number of limited partnerships could have stalled the deal. When buying a contaminated parcel, the buyer must know who will be responsible for remediation costs and legal problems post closing. By establishing an escrow account with proceeds from the sale, the REIT eliminated the risk of the Seller dissolving after the sale. Furthermore, it established the escrow account in such a way as to motivate the Seller to perform their required duties.

Finally, like most brownfields investors, the REIT planned to take full advantage of the available state voluntary remediation program. The Remediation Plan was subject to the reasonable approval of the Buyer and the Buyer had no obligation to approve any plan that was not under the State Voluntary Remediation Program (VRP). The VRP had the advantage of providing finite closure certification upon completion of the remediation and helped to protect the registered owner(s) from any interim litigation, citations, or claims.

Chapter 5

Lessons Learned

As mentioned earlier, I will utilize the case studies conducted by my teammates throughout this chapter. The collection of six case studies should provide for appropriate comparisons and contrasts. While conducting the case studies, we were exposed to four different states, four different end uses (e.g., industrial, office, recreational, and residential), and many different types of principals (e.g., government, private, public REIT). I will begin with a brief description of the other brownfields projects, and then use the entire cache of deals to extract some lessons learned.

Case Studies

An Industrial Manufacturer³⁵

A former manufacturing facility was redeveloped into a state-of-the-art warehouse and distribution center. The site, which was listed on CERCLIS, had both the presence and stigma associated with groundwater contamination and a sludge bed on the site. The investor redeveloped the site as an owner/operator enabling it to manage much of the redevelopment risk. The principal challenges that stood in the way of the deal were purchaser liability, minimizing remediation cost, and resolving back taxes assessed to the site. The transaction documents that played a key role were: the purchase and sale agreement, covenants not to sue, comfort letters, deed restrictions, and a remedial action plan. Furthermore, a “risk based corrective action” approach was utilized to breathe life back into this unproductive site.

Health Center³⁶

³⁵ Evans, John M. “Risk Sharing in Brownfields Redevelopment: a case study approach,” Master Thesis, MIT Center for Real Estate, 1997.

A laboratory, which was engaged in the manufacturing of vacuum tubes, x-ray tubes, and other electronic components, was sold by its parent company, but the sale expressly excluded the firm's facilities and land. The property, which consisted of 12.7 acres, had several areas of soil and groundwater contamination. The seller was a well-capitalized manufacturing firm located in the Northeast. It retained control of the site due to the site's environmental problems and its own potential liability exposure. Despite remediation efforts by the seller, the state DEP was slow to review the site and to issue "no further action" letters. This delay was the result of limited DEP staff and the absence of any formalized remediation standards until many years later.

A potential buyer wanted to build a recreation center at the site. This buyer was concerned primarily with the containment of costs, shelter from environmental liability, and a predictable approval process. In negotiating the relationship between the buyer and the Seller, this case offered strong examples of the role the seller may play in adding value to an impaired property.

Swiss Bank Corporation³⁷

In 1994, Swiss Bank Corporation (SBC) executed agreements with the City of Stamford and the State of Connecticut providing for the relocation of their 575,000 square foot North American operations. The site, which was created through the assemblage of 32 lots, was found to have widespread contamination. Ultimately what convinced SBC to accept this site was a negotiated agreement between the Bank, the State, and the City. A detailed

³⁶ Ibid.

³⁷ Ryan, Shaun. "Brownfields Development," Master Thesis, MIT Center for Real Estate, 1997.

Memorandum of Understanding (MOU) held each party to various commitments. Without the successfully negotiated MOU, the deal would almost certainly have been lost.

Another important requirement of the SBC was that the title of the entire property be held by a government entity, the Urban Redevelopment Commission (URC), until the remediation was complete and the “Covenant Not to Sue” was issued by the DEP. By avoiding the title chain until the last minute, the Bank avoided any unnecessary environmental liability.

10 Trafalger Junction Road³⁸

In 1994, a group of experienced investors pooled some funds together and formed a company for the sole purpose of acquiring a contaminated property in Massachusetts. Their goal was to rehabilitate the property so that it could once again be marketed and sold as a light manufacturing facility. A complex and precisely timed series of events was required to overcome the significant financial and legal obstacles associated with the site. These events included: purchasing the first mortgage position from the bank, conducting detailed on-site contamination investigations, buying the shares of the original debtor corporation, taking that company through voluntary bankruptcy, battling with the town for tax abatement, and finally, obtaining Federal and State sign off documents. The property had been abandoned for almost ten years and it seemed economically unfeasible to all that had bothered to look at it. Thus, this is a case in which the investor’s specific expertise in the brownfield redevelopment process had added significant value by dramatically reducing the risks.

Major Hurdles

³⁸ Ibid.

Land assemblage

In some instances, many brownfields need to be assembled to create one economically feasible parcel. For a myriad of reasons, it is very difficult for an individual investor to attempt to conduct the assemblage without assistance from a government entity. First, as a private investor, one does not have the powers of eminent domain. Second, because the investor must purchase the lots individually, the owners of the last few lots typically present a problem. They realize that their lot is essential to the project, and as such, they deem its value must be greater than market value. However, these issues can be resolved with assistance from state legislative measures.

The state does have the ability under law to take the individual lots and pay fair market value to their owners. If the individual contaminated lots will remain in their current state of environmental disrepair due to their small size, then the state might agree to assemble the site on behalf of an investor whose plans include remediation and redevelopment. In the context of this thesis, it is important to recognize that the state assistance resulted in lower project costs and less risk for the investors.

This is exactly what happened with the Swiss Bank project in Stamford, Connecticut. The State assembled a 12-acre parcel through the acquisition of 32 individual lots. If the State of Connecticut did not conduct this assemblage, the lots would remain contaminated today. Instead, the Swiss Bank Corporation is currently developing their new North American headquarters at the location. The project promises to create 350 new jobs during the construction period and 3,000 permanent jobs by 2008.³⁹

³⁹ Ibid.

This maneuver by the State of Connecticut allowed the Swiss Bank Corporation to shift many of its risks over to the state. Although not solely a brownfields issue, the risk of site assemblage is huge. With the State in control of the process, Swiss Bank did not have to assume this risk. Another important risk shifting mechanism was used by SBC. It would not take title to the property until the remediation was complete and the “Covenant Not to Sue” was issued by the DEP. By avoiding the chain of title until the end, the deep-pocketed corporation avoided unnecessary environmental liability.

Back taxes

Since most brownfields have been inactive for a long period of time, many face problems with back taxes owed to the local municipality. Not to be taken lightly, these taxes can render a project to be economically unfeasible before it begins. The major problem is that in many states, it is unconstitutional for property taxes to be forgiven by the municipality. To resolve this issue, brownfields investors must be creative.

In the Industrial Manufacturer case, the property was saddled with \$330,000 in prior taxes. The town allowed the investors to deed 6.6 uncontaminated acres over as payment (the land was valued at \$50,000 per acre.) The investors then purchased the land back from the Town for \$330,000, which would be paid in 20 quarterly payments over a five year period. This approach allowed the investors to satisfy the debt and eliminate their exposure to the back taxes without eroding the project’s profit margin.⁴⁰

In a separate case, the potential investors of Trafalger Junction Road were faced with satisfying \$1,800,000 in back taxes. Since State law prevented the town from reducing the tax bill, the investors needed to find a creative solution to this hurdle. The investors paid \$5,000

⁴⁰ Evans.

to buy the corporation that owned and at one time utilized the site to operate a foam manufacturing plant. Next, the investors voluntarily put the corporation through chapter 11 bankruptcy proceedings. Although the town could not voluntarily revalue the property and reduce the accrued taxes, a bankruptcy court could force a “compromised judgement.” After one and one half years of negotiating, the town not only accepted \$300,000 payable over five years, but also agreed to an abatement of taxes which would expire after five years.⁴¹

Insurance

It is interesting to note that none of the investors in the six case studies utilized insurance to cap the costs of remediation, and only one investor used insurance to protect against future contamination and third party liability (Trafalger Junction Road). As mentioned earlier, environmental insurance can play a significant role in the redevelopment and transferability of contaminated properties. Most investors stated that if the contamination was quantifiable and able to be remediated, they did not perceive a need for insurance to protect against cost overruns. In addition, remediation contractors were self-insured in case of negligence on their part. As the “better” brownfields are redeveloped and cease to be available, it will be interesting to see how this changes. Will future investors utilize insurance when a site’s contamination is not quantifiable or will these sites be left to lie fallow? In addition, how will the insurers react to this “adverse selection,” where only the riskier projects are insured?

One reason for the lack of environmental insurance could be the cost. Although the price of environmental insurance policies has decreased lately, the cost can still eliminate a

⁴¹ Ryan.

project's profit margin. Since most investors form new entities that have few assets (e.g., Birch Island, the Industrial Manufacturer, Health Center, and Trafalger Junction Road), the investors do have the option of walking from a project if remediation costs are prohibitive. Although this seems extreme, none the less, it is an option.

Government

It should come as no surprise that all six projects utilized state voluntary remediation programs. Once again, the idea behind the voluntary remediation programs is that a third party should be granted protection from liability if they: remediate a site to the satisfaction of the state; avoid perpetuating the contamination of the site; and avoid causing contamination on the site with a new use. The lessons that can be pulled together from the cases revolve around the different experiences each one encountered while using the state program.

Unfortunately, some state DEP offices are still acting like the EPA did under CERCLA. Instead of assisting brownfields investors, they try to hold the new individuals responsible for past contamination and previous debt. The issue of back taxes mentioned earlier is a good example. State and local government should be concerned with correcting the contamination problems and placing properties back on the current tax rolls. Instead, laws prohibit the municipalities from assisting the brownfields investors. Also, when the Health Center project first began, it faced many delays due to a limited staff at the state DEP and the absence of any formalized remediation standards at the time. Many states have corrected these problems as evidenced by the important role that was played by the DEP in the Swiss Bank project. Where the state falls on the learning curve is vital to a brownfields investor. The states with the better programs can make the process easier for the investors and they can

add great value to the project.

Investors

While conducting the case study research, we encountered many “types” of principals. This section will look at these types, and begin to explain how the differences affected the negotiations of risk sharing and/or risk shifting.

Deep Pocket vs. Undercapitalized

The main distinction that was discovered focused on the principals’ available resources. In each case study it was important to determine whom had the deepest pockets, and, as such, what types of continuing protection were extracted from the other parties. For example, when negotiating the purchase and sale document, the seller of the Health Center site included clauses that enhanced its flexibility to deal with future contamination on the site. Since few brownfields are ever restored to a completely pristine site, the seller will remain responsible for future liability under CERCLA. Therefore, the seller wanted to control the method and degree of potential remediation in order to contain costs. One way the Seller achieved this was by restricting the buyer’s ability to assign or sell its interests without first obtaining the consent of the seller. As a further form of protection, the seller had the ability to terminate the transaction if the remediation costs exceeded \$250,000. Had this happened, it may have “warehoused” the site. The key point is that deep pocketed principals will remain “in the deal” forever due to future liability, and therefore, they want to remain “in control” forever.

In a similar situation, the buyer of the Main Street Site was a well-capitalized REIT. As such, it could not rely upon the seller and/or the potentially responsible party to cover any

future remediation efforts. As mentioned earlier, the Buyer was concerned that the Seller was actually a collection of numerous limited partnerships. Fearing that the limited partnerships would dissolve after the Closing, an escrow account was established to cover remediation expenses. By establishing an escrow account with proceeds from the sale, the REIT eliminated the risk of the Seller dissolving after the sale. Furthermore, since it utilized the state voluntary remediation program, the REIT had a defined standard of remediation required that would cap their future liability.

The “deep pockets” of a principal can also affect the actions of the project’s other participants. In the Health Center case where the seller was well capitalized, the buyer opted to not pay for a “Covenant Not to Sue.” They deemed the fees charged (approximately \$50,000) were too high for the protection they would receive. Since the seller would be responsible for any new discoveries or stricter legislation, they decided to avoid paying the fees.

Hold vs. Flip

Brownfields investors can further be divided into two groups; those that will hold the asset for a long period, and those that will flip the asset in a short time frame. When an investor redevelops a brownfield for its own use, it eliminates the project’s marketing risks. For example, the Swiss Bank redeveloped its site as an owner/operator enabling it to manage much of the redevelopment risk. Unlike American Residential, SBC did not have to worry initially about any stigma attached to the site. However, one risk that needed to be assessed by SBC was that, at some point in the future, it would no longer have a need for the property. When this happens, SBC may encounter opposition from the marketplace due to environmental stigma.

American's purpose was to create residential lots that would be sold to homebuilders and homeowners. Although it had experience in the market, American faced considerable marketing risk on Birch Island. There were no comparable projects for O'Connor to study and attempt to understand how the market would react to its product. Since some of the lots were unofficially pre-sold to the Town of Birch Island, American was willing to assume this risk of marketing the remaining lots. The first few sales covered the project's initial costs and the remaining sales would help contribute to the project's profit margin. Finally, because the seller provided American with non-recourse financing, American had the option of handing the project over to the seller if marketing efforts were weak.

Future of brownfields investing

Throughout all of the discussions regarding brownfields redevelopment, people must not lose sight of the fact that these brownfields are still real estate. Many of the basics of real estate development, like "location, location, location," still hold true. Some very sophisticated real estate investors insist that private investors will actually redevelop only a small fraction of brownfields. Many of the choice sites will be redeveloped without government intervention due to their strong locations. For example, the Main Street Site was located in such a prime location and in such a strong market that government incentives such as tax abatements were not needed.

However, as the "cherries are picked" from the available pool of brownfields, more government intervention will be needed to spur redevelopment activities. As mentioned earlier, back taxes present a serious obstacle to these redevelopment projects. All levels of government must band together to resolve this impediment. Furthermore, environmental tax credits can be utilized to help brownfields investors attract equity capital. The success of both

the low-income housing tax credit program and the historic rehabilitation tax credit program have paved the way for future environmental tax credit initiatives. As the choice brownfields slowly dissipate, more government intervention will be needed to lower investor's risk so that the project can be justified on a risk and reward basis.

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