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A Window of Opportunity in the Sale of Environmentally-impaired Property

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Asset liquidation in bankruptcy cases involving real property of manufacturing companies, especially aged facilities, offers many challenges as well as significant opportunities. The sites chosen for the location of manufacturing companies in the early-to-mid-20th century were often near the outskirts of the then existing urban centers. These sites were selected because transportation was not as easy as it is today and a short commute for workers was important. Also, because many manufacturing operations require ready access to water, these facilities were frequently located on river banks.


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Many of these facilities would have to be considered risky operations today because of the high level of pollutants involved in or thrown off as byproducts of these manufacturing operations. Since these facilities were built, cities have expanded their boundaries. Many of these manufacturing sites are now considered "blighted" and are surrounded by vibrant commerce or upscale residential districts. The high intrinsic value of such sites is evident, but the initial prospect of mining these polluted diamonds in the rough is often quite imposing. This article discusses a window of opportunity that exists for the sale of such environmentally impaired real property at a price that is commensurate with its true value.

At the onset of bankruptcy, debtors can be inundated by calls from companies whose business plan is to rush in with offers to "relieve" the debtors of their distressed real property assets. They may paint a picture of gloom and doom regarding the property with scenarios of reporting requirements and injunctions by environmental agencies. Furthermore, the debtor might not be protected by the automatic stay for costs associated with abating imminent threats to human health and environment, and the funds needed to cover such costs might not be available. These conditions are very threatening to a successful reorganization or liquidation. Many feel that the most prudent course would be to contract to sell or even pay someone to take such properties as soon as possible, in the proper manner and with appropriate safeguards to protect the debtor's estate and the remaining value to creditors. Accordingly, the first hurdle to overcome in maximizing value out of these "blighted" assets is that of perception.

There are two key factors to consider before taking the conservative approach of limiting the debtor's liability by quickly transferring the property. The first is that not all old and apparently dirty manufacturing sites will require extensive and immediate environmental action. A good sense of the environmental liability can be gained with a relatively quick and noninvasive examination of the facility. Second, requirements for environmental clean-ups vary both in urgency and extent, and requirements, in general, have changed markedly in the past 10 to 15 years. These two aspects are discussed in more detail below.

With regard to the immediate status of the site, the owner-operator (the owner) is obligated to understand the environmental risks associated with the operation and prohibit the release of virtually any industrial material into the environment. If the owner knows of any release or has probable cause to believe that a release has been made, it must report the condition without delay to the appropriate regulatory agency or agencies, under threat of criminal penalty. If there is an active release of potential pollutants to certain bodies of water, a clean-up must begin immediately, and the debtor will most likely be required to fund that liability. Unfortunately, in the period leading up to a bankruptcy, the environmental diligence of some companies is lax, and objectionable environmental conditions are often created. Also, for newly shut-down facilities, the risk of environmental hazards is particularly high because a hasty termination of operations can leave equipment unsecured and process chemicals or pollutants exposed to the environment. Debtors must therefore gauge the timeliness of their efforts to sell property based on their expectation of what will be discovered in the examination of the property and the possibility that a sale may not relieve the debtor of liability for the clean-up.

About the Author

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Turnaround Topics

Initial Environmental Examination

The usual first step in setting the debtor's expectations is to contract with an environmental firm to perform a Phase I site assessment and make an appropriate report. The report is a formal document produced according to strict guidelines of the American Society of Testing Materials (ASTM). While frequently not overly costly, depending on the site(s) involved the price can rise quickly as it includes a thorough examination of on- and offsite conditions and a review of historical, environmental records. Obtaining a final report can take weeks or even months. While this sort of examination must be conducted at some point of the sale or bankruptcy process, delays in getting results can have a significant and restricting effect on selecting the best strategy for the sale of the property.

An alternative first step is to seek the assistance of an experienced and reliable environmental professional. This individual might be with a major environmental company or might be an independent industry expert. While there is risk in relying on observations made by this person, there is also risk in waiting for and relying on the results of a Phase I report. An experienced environmental professional is capable of examining the site, reviewing a minimal amount of paperwork and conducting industry-specific research. This person can then provide a very good indication of risk in a matter of just a few days. The list of salient items to examine varies, but is relatively short. Items that we have found to be important and which should be included in a "preliminary site investigation" are:

• *What is the industry?* Manufacturing facilities vary greatly in their potential for site contamination depending upon their industry type. Some industries such as glass and paper manufacturing utilize primarily large amounts of naturally occurring raw materials with only a moderate generation of waste chemicals. Other industries such as solvent manufacturing, paint manufacturing or electroplating operations consume petrochemicals or metallic inorganic chemicals in their processes and generate substantial amounts of objectionable waste chemicals.

• *What are the facility practices?* An experienced environmental professional can develop a good idea of the potential for contamination within a few hours of inspecting a facility. Most site contamination is the result of sloppy use of valuable resources. If raw materials or finished products are stored haphazardly, it is likely that there have been frequent spills inside of the buildings and onto the grounds. Also, an examination of the environmental files gives a relatively quick indication of whether there has been responsible environmental stewardship at a facility.

• *What are the physical site features?* If the site is anything but flat, there is a propensity with old facilities to have "made land" over the lifetime of the plant. Lowlands often are filled with spent materials, and riverbanks can be expanded to gain needed real estate. An examination of old photographs or even just a look at the general terrain feature will most likely indicate any presence of unauthorized and unlawful landfill. The fill materials, while not necessarily recognized at the time as being hazardous to the environment, are often process-related and frequently objectionable by today's standards. The most storied example of this was the massive unregulated landfill created by Hooker Chemical in the 1940s at a site called Love Canal. Another key physical feature is the presence of above and below ground storage tanks and whether the piping is above or below ground. Spills and ground contamination almost always accompany storage tanks.

• *What are the local geological conditions?* The geology of a site governs the two main cost drivers of an environmental clean-up. The first driver is the potential depth of the soil excavation when contamination has occurred. Generally soil is removed only down to the groundwater table. So the difference in environmental exposure is vast for a site with the groundwater at six feet below grade versus one where the groundwater is down 50 feet. The second main driver is the geologic fate of the groundwater. Dispersion of contamination will be much less if the water conductivity of the soil is low. Conversely, in sandy, high-conductivity soils, contamination can travel fast, resulting in much contamination from relatively small spills. Also, with respect to groundwater, if the predominant flow is in the direction of an area in which domestic wells exist, there is a much greater need for response compared to a situation in which the groundwater flows in a direction in which groundwater use is impractical or impossible.

As most of the information included in the above list can be obtained and communicated within just a few days, a debtor can quickly get a sense of urgency regarding environmental matters. It is also likely, due to the non-invasive nature of the investigation, that an immediate reporting responsibility to an environmental agency will not be triggered.

Changes to Environmental Regulations Governing Site Remediation

Understanding the impact of environmental contamination is an immense and complex task. So it is not surprising that in the infancy of this country's regulation of solid waste, certain precautions were taken that went beyond what was necessary to protect human health and the environment. The Resource Conservation and Recovery Act of 1976 (RCRA) established a far-reaching program of "cradle to grave" responsibility that left owners of operations responsible for whatever hazardous waste they generated. Also, the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA or Superfund) further solidified the responsibility of generators to protect the environment and in many cases tied this responsibility to landowners, whether or not they were the actual generators of the waste. The implementation of the rules governing the clean-up of contaminated sites generally fell on the states. Furthermore, the common standards for soil and groundwater cleanliness set by the states were either nondetection of any contamination or contaminant levels not exceeding background levels in the respective area. Also, with the connection of environmental responsibility to landowners, the selling of contaminated land became very difficult.

As more was learned about the effects of contamination, it was determined that clean-ups do not have to proceed to zero measurement of contamination, and over the years, risk-based tolerable exposure and *de minimis* levels of contamination were determined. Accordingly, many states have adopted a risk-based clean-up approach, commonly called Brownfields, and federal regulations were amended to allow for indemnification of land purchasers. Regarding the risk-based

approach, there are three key elements to this methodology. First, elaborate tables of exposure standards have been accepted by a number of states, and use of these standards has significantly streamlined and reduced the cost of clean-ups. The second element is that more important than removal of contamination is the blocking of the exposure pathways. So, practically speaking, if humans and the environment cannot inhale it, ingest it or touch it, then it might be possible to leave the contamination in place. The third element is that special situations are recognized such that alternate standards will apply. Most states have one set of risk standards for residential property and another set of less-stringent standards for industrial property. Also, special standards can be requested under controlled environments, such as restricted or fenced-in areas.

Another new development in opportunities regarding the revitalization of industrial property is an opportunity to offset environmental clean-up costs against future *ad valorem* taxes. Some states have programs in which certain *ad valorem* taxes paid on the property can be set aside and participants in their programs can recoup this money to offset funds expended on the environmental remediation of the property. In some cases, the full amount of qualified clean-up expenses can be recovered.

Recognizing a Window of Opportunity with a Strategy for Sale

While any number of site condition scenarios is possible, the focus of this article is on those in which a preliminary site investigation yields favorable results. Certainly, there are no guarantees of a trouble-free outcome. However, with the proper information it will be evident whether a controlled sale or development, or a cut-and-run strategy, should be adopted. If the outlook is favorable and the proper actions are taken to select a plan to sell the property, there are several key actions to take in setting up for sale.

Buyers like to have hard environmental data, but with respect to this data, they like to have their own data. There is generally minimal benefit to the seller to invest a large amount of money making an upfront comprehensive environmental site assessment. It is better, when time permits, to have limited testing done to provide a preview of the environmental condition of the site to prospective buyers. A good characterization of the site can be done by selecting testing locations dictated by identifying likely areas of contamination. Such an approach will provide valuable information to buyers who are used to dealing with contaminated property and not be so complex that it will cause buyers who are normally only interested in Greenfield, or formerly unused, sites to shun the property.

Regarding the prospective buyers, assuming that one is dealing with what appears so far to be only marginally contaminated property, there can be a variety of types of sales agreements. The most common examples are third-party funding and seller funding. In the first example, buyers pay cash to the seller and rely on third-party funds to complete the transaction. However, the purchase cannot close before the funding source receives a full and comprehensive environmental assessment, which may well include more than the Phase I assessment discussed above, and satisfies itself that it is willing to lend into this "blighted" situation. In this type of sale, the agreement should be structured for the buyer to fund the assessment and provide the results to the seller whether or not the sale is consummated. While in this form of transaction the buyer cannot later put the property back to the seller, there is always a danger that if the buyer fails to complete any clean-up required by the assessment, a regulatory agency may seek to force the seller to fund completion of any clean-up required by the assessment. For this reason, having the results of the original assessment is important. In the second example, a buyer may seek to give the seller a cash down payment and a mortgage for the balance of the purchase price. Typically, most sellers will only require a Phase I assessment on the environmental issues for the benefit of the buyer because they already know the property and its environmental condition and, unlike a third-party lender, are already responsible for any contamination on the site. In this second example, the seller also has an ongoing interest in the property, and in the event that the buyer defaults on any of its obligations, the seller may well end up with title reconveyed to it as mortgagor. The purchase agreement in this instance must include rights for access to all information related to the Phase I assessment and all work conducted on the site. The seller must also establish assignment rights for any agreements entered into by the buyer with commercial entities or governmental agencies.

Other options for disposing of the property in lieu of an outright sale include a deferred sale option, which involves contracting with a third-party environmental firm that would agree to clean up the property at their cost in return for a specified rate of return on their investment to be satisfied out of the eventual proceeds from a sale of the property, and an option whereby the seller buys clean-up insurance and sells the property with insured funding of the clean-up. The cost of such insurance being relatively expensive, this option likely involves more certainty of a sale closing, but significantly lower returns to the creditors.

Have a "Plan B"

One final consideration in the sale process is having a Plan B. With the sale of environmentally impaired property, the old cliché, "meat's not meat until it is in the pan," could not be more appropriate. It is common for buyers to try and renegotiate sales terms, or "retrade," based on new environmental discoveries. When the sale is conditional on favorable results in an environmental assessment, there is never a bright line for what is good and what is not. Furthermore, buyers experienced in buying impaired properties might be relying on this uncertainty as a basis for retrade. Also, if the property is sold with a mortgage to the seller, retrading, based on the buyer's perception of new and untenable environmental discoveries, is always on the table. It is imperative that the seller reserve enough funds to be able to accommodate a terminated contract or a retrade effort by a buyer.

Conclusion

At the very beginning of the process of deciding whether to sell potentially environmentally impaired property, it is important to add three key steps to your action plan. First, it is critical to obtain early environmental information and not be misled by unsubstantiated environ-mental horror stories or intimidated by outsiders attempting to rush a sale. Second, the debtor should recognize that environmental laws have changed for the better and that programs now actually exist to facilitate a good outcome from a sale. Third, the debtor should have a Plan B—because "meat is not meat until it is in the pan." ■

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