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Contaminated properties as the new investment niche in tight real estate market

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

There are at least 100,000 contaminated sites in California — with estimates of fair market value in the hundreds of billions. While the risk and hold times may not appeal to every investor, the rate of return can be substantial. Several recent changes have made the risk more manageable than it has ever been.

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

Regulatory reforms, due diligence

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

The driving force behind due diligence has historically been the Comprehensive Environmental Response, Compensation and Liability Act/Superfund Amendments and Reauthorization Act (CERCLA/SARA). Enacted in 1986, SARA serves as an addendum to the original Superfund law of 1980.

To date, CERCLA, or Superfund, has established prohibitions and requirements concerning closed and abandoned hazardous waste sites; provided for joint, strict and retroactive liability of persons responsible for releases of hazardous waste at these sites; and established a trust fund to provide for cleanup when no responsible party could be identified.

Superfund has always had an "out" by allowing the assertion of the "innocent landowner defense" to liability, requiring that "all appropriate inquiry into the previous ownership and uses of the property be consistent with good commercial or customary practice."

Until recently, the criteria to qualify as an innocent landowner were uncertain at best. Fortunately, recent amendments to Superfund clarify what constitutes "all appropriate inquiry."

The amendments, which became effective in 2002, embrace the American Society for Testing and Materials Standard Practice for Environmental Site Assessment. The amendments require the Environmental Protection Agency to adopt regulations within two years that establish standards for "appropriate inquiry." The EPA is currently working with stakeholders on this process.

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

For developers looking to acquire a contaminated property, performing due diligence means conducting a thorough — and required — Phase I site assessment, which should meet or exceed the updated ASTM guidelines. A typical Phase I conducted by an environmental consultant includes site reconnaissance, interviews with onsite and offsite sources, regulatory reviews and thorough analysis of the site and site vicinity history.

Environmental insurance

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

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

There are four major types of environmental insurance coverage:

- *Cost cap/Stop loss* works for anyone involved in remediating contaminated properties. It minimizes uncertainty by paying for defined cleanup costs that exceed the anticipated cost of cleanup, and provides a buffer above the expected cleanup costs. A remedial action plan is usually a prerequisite to obtain this type of coverage.
- *Environmental Impairment Liability* coverage is site specific and covers first and third parties. It covers pre-existing and new claims for known conditions. Policy terms can extend up to 10 years, with coverage ranging from $15 million to $100 million.
- A *Finite Insurance Program* may include the entire expected cleanup costs. It usually is recommended for projects of $4.5 million and up, although small project are sometimes considered. A finite program requires a remediation action plan and accurate estimation of annual cleanup costs.
- *Lenders Coverage* is designed to protect lenders from loss of collateral value; the inability of the borrower to repay the loan; and liability of environmental conditions on foreclosed properties. Lenders coverage might make lenders more willing to provide capital on contaminated properties.

Prime investment sites

Sites with leaking underground storage tanks are excellent redevelopment candidates. Remediation for leaking underground storage tanks often can be reimbursed through a state cleanup fund or covered by insurance. Risk-based corrective action may facilitate the redevelopment and cleanup of these sites.

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

In addition, almost all urban areas encompass numerous brownfield properties in need of remediation. With increasing demand for in-fill development opportunities, soaring housing prices and pressure for smart growth, urban cores are prime locations for the acquisition and redevelopment of brownfields properties.

Real estate investments carry their share of risks. Some properties are truly "upside down" and, even if available at zero cost, are not worth it. However, for the savvy investor, "dirty dealing" can be an interesting and rewarding experience.

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