



RISK BULLETIN

Leased Properties - Environmental Risk Management Practices

OVERVIEW

The 1993 ASTM Phase I Environmental Site Assessment (ESA) standard revolutionized the manner in which environmental conditions are addressed during property transactions. The key component of the Phase I ESA is its ability to



identify recognized environmental conditions and provide a due diligence process to help parties address CERCLA liability for releases or threatened releases of hazardous substances. Since the advent of the Phase I ESA and during subsequent revisions (1997, 2000, 2005), banking institutions, real estate organizations, property owners, the

legal community, and other groups have embraced its value as a method to identify potential environmental risks. Phase I ESAs are now a part of doing business and as common in the due diligence process as the financial analysis element.

For owners of leased commercial and industrial properties, it is equally important to understand and manage environmental risks presented by existing and prospective tenants. This will help minimize pollution liabilities associated with bod-

ily injury, property damage, and legal defense. Proactive due diligence and risk management may also help limit liabilities from environmental impacts identified during future Phase I and II ESAs and reduce any remediation expense obligations. Attention to the manner in which tenants manage operational environmental risks contributes to maintaining profitable properties and limits the costs of addressing environmental conditions and claims.

The use of the triple net lease by many real estate organizations places the majority of repair and maintenance responsibilities on the tenant. As such, it is not uncommon for a landlord to have infrequent visits to a property and sometimes only at the termination/renewal of the contract. Operations conducted by tenants may change during the course of a lease, especially those with long terms or automatic renewal options.

Common exposures associated with changing tenant conditions include:

- The addition of new production processes to support expanding or new business ventures;
- Space modifications, including the removal of facility floors, to accommodate new equipment;
- The introduction of new chemicals;
- Storage of greater quantities of chemicals in the form of new tank storage or increased drum storage;
- Inadequate maintenance resulting in exposures associated with water intrusion/mold, asbestos containing materials, or lead-based paint.

Although lease conditions may place environmental cleanup liabilities onto the tenant, failure of the tenant's business or financial insolvency may ultimately place cleanup costs and liabilities back onto the property owner. Additionally, environmental cleanup efforts are likely to delay new tenant leasing resulting in a loss of rental revenues.

The development of a sound environmental management program for property owners and leasing organizations helps prevent or minimize environmental impacts from tenant operations. Key elements in developing a program include the use of a lease with adequate terms/conditions related to environmental impairments, documenting site conditions before and after tenants occupy a property, and the development and adherence to an environmental inspection program.

LEASE TERMS AND CONDITIONS

It is critical that landlords utilize a lease with environmental terms and conditions to set expectations during the lease period and provide the basis for legal action in the event environmental impacts are identified. It is important to engage legal counsel to create or review environmental terms and conditions in lease contracts. Environmental language recommended for use in commercial leases includes:

- Requiring prior approval from the landlord before tenant renovations;
- Requiring tenants to carry environmental insurance;
- Performing annual reviews of chemicals utilized in the space and requiring prior approval for the use of new chemicals;
- Seeking landlord indemnification for contamination caused by tenant operations;
- Authorizing the landlord to inspect the space with proper notice;

- Listing prohibited activities within the lease including the installation of underground tanks, installing bulk tanks without notice to the landlord, and failure to comply with local, state, and federal environmental regulations;
- Requiring tenants to adhere to existing institutional controls and conditions outlined in regulatory agency No Further Action (NFA) letters or consent agreements (e.g., engineered barrier maintenance, use restrictions, construction worker notification, access agreements);
- Allowing the landlord to take over any environmental remediation effort if certain conditions are not met

BASELINE INVESTIGATIONS AND EXIT ASSESSMENTS

Establishing a baseline of existing environmental conditions prior to leasing space to a new tenant is critical for both the landlord and the tenant. The tenant does not want to be liable for environmental impacts caused by

the previous occupant and the landlord is motivated to formally document that the property is free of environmental contamination prior to entering into a new lease. Understanding site conditions prior to occupancy via the performance of a Phase I ESA and a subsequent Phase II soil and groundwater investigation, if required, assists in identifying responsible parties in the event of a future cleanup.

States laws and regulations pertaining to environmental conditions associated with property transfers may also apply. For example, the Michigan Department of Environmental Quality has a formal process, the baseline environmental



assessment (BEA), which must be performed by new owners and operators of property that “might be contaminated” in order to qualify for liability protection. In California, property owners must notify tenants if there is a known or suspected release of a hazardous substance onsite (California Health and Safety Code Section 25359.7).

Equally important is the completion of an exit assessment prior to the departure of a tenant. Similar to the baseline investigation, a Phase I ESA and subsequent investigations, if necessary, are performed to identify impacts, if any, to the property during the term of the tenant’s lease. At this time, the land owner may be able to withhold security deposit funds until appropriate actions are taken to characterize impacts or address environmental issues.

INSPECTION PROGRAMS

Once a lease has been signed and the baseline assessment has been completed, it is critical



that property owners follow an inspection program to ensure that environmental impacts are identified and limited. Often, inspections during the lease period are neglected because of time commitments or concerns regarding tenant relations. It is recommended that property owners seek professional assistance with the development of an inspection program. It is not uncommon for land owners to contract an environmental professional, typically a consulting firm with a specialty in Phase I and Phase II ESAs, to conduct the audits. However, it is not uncommon for a program to be developed in-house. Key components of an inspection program include:

- Description of operations performed with particular attention to new operations and processes since the previous assessment;
- Chemical storage assessment with attention to hazard classifications (flammable, corrosive, oxidizers, etc.), storage of incompatible materials, primary and secondary containment, container types, and tank management practices for USTs/ASTs;
- Waste management review including storage practices, waste manifest review, generator status, non-owned disposal site auditing;
- Compliance with air, water, and waste permits which may be maintained based on operations conducted;
- Visual impacts to the site such as concrete stains in chemical storage or process areas or stressed vegetation;
- Presence of asbestos, mold, or lead-based paint and the adherence to an Operations and Maintenance program;
- Adherence to existing deed restrictions and institutional control requirements such as the maintenance of engineered barrier maintenance, land use restrictions, and proper construction worker notification programs

Specific tenant operations may require the inclusion of additional inspection criteria. It is important to investigate common impacts associated with a tenant’s industry.

Once an issue is identified during the inspection process, a corrective action procedure must be implemented in order to address the risk. The process must be documented for future reference and clearly outline areas of concern along with required remedies. It is recommended that a timeframe for completion be established and that the land owner require documentation of the action(s) taken by the tenant to address the risk. The corrective action process shall include actions to be taken in the event the tenant does not adequately address the concern.

CONCLUSION

Benefits to developing an environmental program in conjunction with traditional property management activities include an improved due diligence process if the property is sold, the ability to minimize impacts from tenant operations through early detection of issues, a greater ability to assign cleanup responsibilities to tenants through documented baseline and exit assessments, and fewer prolonged tenant transitions due to environmental cleanup efforts. These controls will help minimize liabilities associated with tenant operations, hazardous material use, and potential environmental claims.

REFERENCES

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<http://epa.gov/brownfields/regneg.htm>
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