

*Winter 2006*

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## EPA Crafts Legal Standard for Environmental Due Diligence in Property Transactions

*Amy McMorrow and Doug Henderson, Troutman Sanders LLP*

Buying and selling property may never be the same again. On November 1, 2005, the U.S. Environmental Protection Agency ("EPA") ended a long wait by publishing a Final Rule that details the environmental due diligence required in order to take advantage of certain liability protections provided in the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA"). The product of a negotiated rulemaking process, this Final Rule defines once and for all what is required to demonstrate that "all appropriate inquiries" ("AAI") have been conducted in connection with property transactions and is expected to set the legal standard for Phase I Environmental Site Assessments ("ESAs"). Anyone involved in real property transactions should pay particular attention to the changes brought about by this Final AAI Rule, as their traditional due diligence practices may not provide sufficient protection against future liability for contaminated property after the Rule goes into effect.

### Background

The Small Business Liability Relief and Brownfields Revitalization Act of 2002 (the "Brownfields Act") revised the existing "innocent purchaser" defense to CERCLA liability and created additional defenses such as the "bona fide prospective purchaser" and "contiguous landowner" defenses. Each of these defenses requires that the purchaser must first conduct "all appropriate inquiries . . . into the previous ownership and uses of property in accordance with generally accepted good commercial and customary standards and practices" in order to take advantage of the defenses. Prior to the adoption of the Brownfields Act, this standard was undefined and it was up to the courts to determine what constituted AAI. The Brownfields Act however, sought to define AAI and required that EPA promulgate regulations to establish standards and practices for AAI, in accordance with a set of ten criteria provided within the statute. The Brownfields Act further provided that the current American Society for Testing and Materials (ASTM) Phase I standard would serve as the interim standard for AAI, prior to adoption of EPA's regulations.

### Key Points

EPA's Final AAI Rule expands the scope of due diligence required to satisfy the AAI standard and enhances the role of the environmental professional conducting such due diligence. The following key provisions should be noted:

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## Message From the Chair

Jeff Dehner

Dear Section Members:

We hope you enjoy this edition of our newsletter. Thanks as always to the contributors as well as our dedicated editor, Andrea Rimer. I would also like to take this opportunity to congratulate and welcome our newly-elected 2006 Section Officers. They are:

Chair: David Meezan

Chair-elect: Andrea Rimer

Secretary: Martin Shelton

Treasurer: Bill Sapp

Member-at-Large: Anne Marie Stack

Obviously, the selection of our 2006 Board contemplates the close of the 2005 Board's service, particularly that of your current Chair. As such, I'd like to thank each of you for the opportunity to represent the Section. I truly believe that the level of expertise and the basic calibre of the individuals who make up our membership is unmatched within the Georgia Bar. Thus, it has been my pleasure and privilege to serve on your behalf during the past four years. Our area of practice remains vital and challenging, and based your choices for next year's Officers, I am confident that the Section will continue to provide valuable benefits to its members.

Best wishes for a prosperous 2006,

Jeff Dehner

## EPA CRAFTS LEGAL STANDARD FOR ENVIRONMENTAL DUE DILIGENCE IN PROPERTY TRANSACTIONS

*Continued from page 1*

- A site investigation must be overseen and certified by an "environmental professional," which is now defined as a person who "possesses sufficient specific education, training, and experience necessary to exercise professional judgment to develop opinions and conclusions regarding conditions indicative of releases or threatened releases on, at, in, or to a property, sufficient to meet the objectives and performance factors" and who meets minimum objective standards specified in the Rule for licensing, education, and relevant work experience;
- An interview with the current owner or occupant (and, to some extent, former owners or occupants) of the subject property is now mandatory;
- An interview with neighboring or nearby property owners is now mandatory for certain abandoned properties;
- The review of past uses and potential historical sources of contamination must now extend from the present to when the property first contained structures or was first used for residential, agricultural, commercial, industrial or governmental purposes;
- The review of existing institutional controls and environmental cleanup liens with respect to the subject property may be conducted by either the environmental professional or the prospective property owner and must now include all liens filed or recorded under federal, state, tribal or local law (the review is no longer limited to reasonably ascertainable land title records, but it is now limited to the subject property);
- Where there are gaps in the data collected by the environmental professional, regardless of whether certain information cannot be obtained or is withheld from the professional by the prospective purchaser, those gaps must be identified and commented on with regard to the impact that each data gap may have on the ability of the environmental professional to identify conditions that may indicate releases or threatened releases;
- An on-site visual inspection must be performed on the subject property (unless a limited exemption applies), and a visual inspection must be performed for adjoining properties from the subject property line, public rights-of-way, or another vantage point;
- An assessment of the relationship between the actual purchase price and the fair market value of the property must be conducted by either the environmental professional or the prospective purchaser;

- Any specialized knowledge of the prospective purchaser, such as significant experience in real estate transactions or brownfields redevelopment, must be disclosed; and
- All environmental due diligence, as well as written reports documenting such diligence, must be completed within one year prior to the property transaction, and certain elements must be updated to ensure that those elements have been satisfied within 180 days prior to the transaction.
- All environmental due diligence, as well as written reports documenting such diligence, must be completed within one year prior to the property transaction, and certain elements must be updated to ensure that those elements have been satisfied within 180 days prior to the transaction.
- The rule does not apply to property purchased by a non-commercial entity for “residential use or other similar uses” where an inspection and title search have revealed no basis for further investigation

Although the Final Rule does not differ drastically from the interim standard, these changes and others warrant a careful review of due diligence practices. Parties involved in a property transaction should fully understand their respective responsibilities under the new standard, and environmental professionals need to be involved in the process early enough to complete the activities required to satisfy the Final Rule. In addition, because the Final Rule expands upon existing due diligence requirements, the cost of conducting such due diligence, both financially and in terms of the time investment required, is expected to increase. The enhanced due diligence will likely trigger an increased number of Phase II investigations, and affected parties should be made aware of the additional time necessary to finalize the assessment process.

## Effective Date

The Rule will become effective on November 1, 2006, one year after publication in the Federal Register. Until then, compliance with either the Final Rule or the interim standards will satisfy CERCLA’s statutory requirement for all appropriate inquiries. In addition, ASTM has updated its standard for Phase I ESAs to incorporate EPA’s newly finalized regulations, and EPA has indicated that compliance with the new ASTM Phase I Standard E1527-05 will satisfy the requirements of the Final Rule. After November 1, 2006, those subject to the Final Rule must comply with either the Final Rule or the new ASTM Phase I Standard E1527-05. Because transactions finalized on or after November 1, 2006 will likely rely on due diligence conducted prior to that date, it may be prudent to

require compliance with the Final Rule or the 2005 ASTM Phase I Standard well in advance of the November 1st deadline.

## The Final Rule In Practice

The new standard will likely change how Phase I ESAs are actually produced by environmental consultants, and how they are used by prospective purchasers, lenders, and equity investors. Historically, the vast majority of Phase I ESAs have not been conducted in strict compliance with the applicable ASTM E1527 standard. Although Congress and EPA set out interim standards that utilized the 1997 and 2000 versions of the ASTM E1527 standard, a certain amount of ambiguity about the practical requirements of “all appropriate inquiries” persisted, and environmental consultants often produced Phase I ESAs that were only “substantially in compliance” with the ASTM standard. This practice of preparing “substantially compliant” ASTM Phase I ESAs, however, may now be at an end. Now that EPA has defined the legal standard for environmental due diligence in real property transactions, and blessed the ASTM E1527-05 standard as a proxy for the Rule, there may be less tolerance for “substantial compliance,” and more emphasis on the ability of consultants to certify that their investigation fully satisfies the new legal standard. Instead of substantial compliance, strict compliance with the Agency’s Final AAI Rule or the 2005 ASTM E1527 standard may now become the rule. ♦

<sup>1</sup> 70 Fed. Reg. 66070 (Nov. 1, 2005); 40 C.F.R. Part 312 (2005).

<sup>2</sup> 42 U.S.C. § 9601(35)(B) (2005).

<sup>3</sup> While the “all appropriate inquiries” definition was under development, compliance with either the ASTM Standard E1527-97 or E1527-2000 (Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process) satisfied the Act’s statutory “all appropriate inquiries” requirement, depending on the transaction date. 42 U.S.C. § 9601(35)(B)(iv); 68 Fed. Reg. 24888 (May 9, 2003).

<sup>4</sup> See EPA, *Comparison of the Final All Appropriate Inquiries Standard and the ASTM E1527-00 Environmental Site Assessment Standard*, EPA-560-F-05-242 (October 2005). The ASTM E1527-05 Standard has recently been finalized and is available through [www.astm.org](http://www.astm.org).

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# Practical Challenges in Water Withdrawal Permit Transfers

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Competition among water users, driven by continued population growth in metropolitan Atlanta and the Georgia coast, has compelled Georgia's citizens, politicians, and bureaucrats to expend tremendous energy in the last seven years to improve the management of Georgia's water resources. Questions about ownership and regulation of surface and ground water are now concerns of all water users, not just a few isolated parties, and some basic questions color all aspects of policy development, legislation, and water management planning:

- Who owns water and water withdrawal permits in Georgia?
- Who decides who gets Georgia's water and how it will be used?
- Should a commercial market exist to trade in water rights or permits?

## Who owns water in Georgia and what do they own?

Many people are confused about the nature of water ownership, water rights, and water use permits in Georgia, which has sometimes led to ineffective debate on water policy. Georgia's water law is a mix of common law, case law, and statutory law. Georgia has a regulated riparian system of water rights, meaning that a riparian (stream-side property owner) has a right to use water flowing by or on his property:

Riparian proprietors have a common right in the waters of the stream... Riparian proprietors have no title to the water which flows over their land, but are entitled to a reasonable use thereof... The property, therefore, consists not in the water itself, but the added value which the stream gives the land through which it flows. Price vs. High Shoals Mfg., 132 Ga. 246 (1909).

The property owner owns the channel banks and bottom (except for navigable or tidal waterbodies) but does not own the actual water, merely the right to use that water. On the other hand, the state does not own the water, either. The state's authority to regulate the use of water stems from its police power to provide for safe and orderly public intercourse by insuring that water use by one does not unreasonably interfere with water use by another. The state requires that persons desiring to withdraw surface or ground water in amounts greater than 100,000 gallons per day obtain a permit.

Thus, there are currently two aspects of water ownership in Georgia: 1) ownership of a riparian right to use, and 2) exercise of that right by possessing a state-required permit. Much debate in formulating water policy, particularly with regard to how water use may be transferred, stems from the incorrect assumption that these two entities are identical. Conservation groups have preferred to recognize only limited private ownership and seem to promote a state-centralized authoritarian system for allocating what they consider to be public property among users. Business groups have equated permit possession with a right to use (and vice versa) and want to have the best of both worlds: the innate right of use engendered in riparians combined with the free-market transferability and temporal priority of a prior appropriation water rights system.

In Georgia, a riparian right is different from other property rights because it is inseparable from the riparian property. Currently, there can be no transfer of a riparian right without transfer of the riparian real property, so unless the legal basis changes, the debate must center on transfer of a permit to withdraw rather than transfer of a riparian right. In this respect, the Georgia Environmental Protection Division does not recognize separability of a permit from a right, and only allows a permit transfer if the property where the water is used is transferred as well, and the permit stays with the originally authorized use and location.

## Should we allow permits to be transferred?

The tougher question is whether a permit can be transferred off-site, modified to allow a different use at a different location. The expected scenario is one in which a water management authority determines that a river or aquifer is fully utilized with no available capacity to supply additional users. A person proposing a new use would then buy an existing permit from a water user who voluntarily gave up his permit, presumably for money paid by the new user.

Would such transfers facilitate effective management of water resources? The American Society of Civil Engineers' Regulated Riparian Model Water Code suggests that the "State shall encourage and enable the sale or other voluntary modification of water rights subject to the protection of third parties and the public interest." Voluntary transfer of permits might allow supply and demand in a water permit marketplace to determine the best (most reasonable) uses of water and to provide flexibility in meeting economic, environmental, and social goals.

However, opponents of permit transfers doubt whether market forces can truly determine reasonable use when the supply is finite and small in proportion to demand. They fear establishment of an unregulated market for water permits in which water flows only toward money. Additionally, some view money-driven permit transfers as unfair

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profit from a state supplied and free resource and even suggest that if a state-issued permit has a value, the state should be compensated for providing the permit. Also, purchase of an existing permit might allow a prospective water user to jump ahead of other permit applicants who are unable to afford purchase of an existing permit regardless of the relative reasonableness of several proposed uses.

Perhaps both sides of this argument are overstated. Merely allowing water permit transfers does not necessarily create a water market. Joseph Delapenna (2002) stated, “Markets are best for allocating and distributing resources when they work. True free markets for water are rare and have been seldom used to bring about change in water use. Economic incentives as a regulatory tool are different from markets.”

While economic incentives from a prospective permittee to a permit holder may smell like an open market, state oversight of permit transfers is almost certain and would likely include regulatory review commensurate with the magnitude of the change in location or type of use. Additionally, permit transfers could be required or encouraged by the state through involuntary re-allocation or state-sponsored incentives (Barmeyer, 2005). Georgia already has the ability to exercise involuntary re-allocation, a cornerstone of true riparianism, but it only applies this ability on a limited basis during extreme drought. State-sponsored incentives to give up all or a portion of permitted water use have been offered to farmers under the Flint River Drought Protection Act. Given that state-sponsored economic incentives and involuntary re-allocation already exist, is it unreasonable to allow a third option for voluntary permit transfer: incentives between private parties with state regulatory review?

## Would anybody really want to transfer a permit?

The Durango-Georgia paper mill in St. Marys, Georgia raises this and related questions. The mill, now bankrupt and not operating, holds a permit to withdraw over 40 million gallons per day. With paper prices low, the mill unlikely to reopen soon, and a state-imposed moratorium on additional withdrawals from the Floridan Aquifer, some view the permit as a valuable asset. Can Durango sell its permit to other prospective water users? Is it selling an actual permit or the water withdrawal capacity supposedly made available by its reduction in use? What happens if it transfers its withdrawal capacity to others but then wants to reopen the mill? In an effort to head off this debate, the Georgia Senate passed SR 904 urging Georgia EPD to immediately revoke Durango’s permit. Interestingly, this resolution was spurred not by conservation groups opposing permit transfer but by business groups who wanted the water formerly used by Durango to be generally available to prospective permittees who were otherwise prohibited from obtaining withdrawal permits by Georgia EPD’s moratorium.

The recent legislative debate over HB 237 raises another interesting question. If you can’t sell your permit, can you give it away to a friend even if others might pay a higher price? HB 237 contained a provision to allow a permit holder to voluntarily abandon all or a portion of a permitted withdrawal in return for the state allocating that withdrawal to the former permitholder’s designee. Such a transaction essentially relies on exchange of social capital rather than monetary capital. Is this an effective way to allocate limited supplies?

## Who decides who gets Georgia’s water and how it will be used?

The Durango-Georgia and HB 237 examples highlight voluntary transfer of permits as a means of allocating a scarce resource. However, before a permit can be transferred it first must be issued, so the initial allocation in permitting is where we encounter significant challenges in water management. The state, as the permit issuing authority, decides who gets to use Georgia’s water. Establishment of regional water planning authorities, such as the Metropolitan North Georgia Water Planning District (MNGWPD), is an accelerating trend that installs an intermediary between permit applicants and the Georgia EPD who act to filter out prospective water uses that are not consistent with the regional water management plan.

How does a regional authority or the state decide among users when the available water supply is less than the desired uses? The clearest lesson comes from the MNGWPD which has been much more proactive than the state in identifying types of use and even specific projects that have highest priority. On the one hand, having a water management plan is a good thing, but on the other hand, it is not clear what recourse exists for a project not identified in the plan. Is political lobbying to be included in a regional water management plan demonstration that a prospective water use is “reasonable?” Again, the MNGWPD attempts to avoid an exhaustive listing of all possible uses and the problem of allocating on a first-come first-served basis by allocating at least partially based on county-approved land use plans.

## What is reasonable use?

Georgia’s regulated riparian system requires that a use be reasonable, but there is no strict definition of “reasonable” beyond a prohibition against unreasonable impact on other users. There is certainly no list of the types of uses that are considered reasonable or unreasonable, although Georgia law does prioritize agricultural use over industrial use during emergency shortages. Do we want or need to further codify reasonable use? A flexible definition of “reasonable” seems appropriate for allowing communities to identify different and changing priorities. However, guidelines for reasonable use that are more substantial than a prohibition against unreasonable impact or emergency prioritization seem likely to better facilitate water management. Again, the American

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# Purchasing and Owning Contaminated Property: A Primer for Property Owners

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It was not that many years ago that the idea of deliberately purchasing contaminated property would have been viewed as conclusive proof of some strange form of dementia. The range of problems associated with contaminated property was both formidable and self-evident: potentially devastating cleanup costs; tort liability to residents and owners of nearby property; unpredictable restrictions on use and development of the property; and interminable legal headaches and regulatory distractions. Not only that, any competent attorney or consultant would have emphasized that there were simply no available means to quantify or limit any of these exposures.

It would be too much to say that the conventional wisdom of years ago has been completely negated. There are still potential pitfalls in purchasing and owning contaminated property, and careful planning accompanied by informed advice is required. But it is not too much to say that there are now legal, technical, and economic means available to overcome nearly all of what were formerly considered insurmountable obstacles. To be sure, these solutions come at a cost, and it may well be that the costs to implement these solutions simply outweigh the potential profitability of any given real estate deal, but one can now at least safely consider a purchase of contaminated property without fear that one will inevitably end up institutionalized for having entertained the prospect.

This article provides a very brief overview of the sorts of issues one should think about in purchasing and owning contaminated property. In that regard, the purpose of this paper is two-fold: (1) To summarize briefly the range of potential issues to be considered in purchasing or owning contaminated property and (2) to survey the range of methods available to address these issues.

## Risks in Purchasing and Owning Contaminated Property

Broadly speaking, there are four categories of potential problems whenever a person owns contaminated property: (1) cleanup obligations; (2) liabilities to third parties; (3) obstacles in selling or financing the property; and (4) limitations on the property's use.

Before addressing these risks, however, it is also important to acknowledge that it is not only the existence of environmental risks that complicates contaminated property transactions, it is also, and sometimes even more so, the uncertainty of those risks. Businesses

can be quite adept at incorporating known costs into the analysis of a potential real estate transaction. The difficulty in the environmental context is that the costs associated with environmental matters can be both highly uncertain and potentially unbounded. For that reason, one should think of the following risks not only for what they portend for out-of-pocket costs, but also how they play out in the risk aversion profiles of involved parties.

### *Cleanup Obligations*

The most obvious risk associated with impacted property occurs because federal law, and most state laws, make the owner of contaminated property potentially liable for all costs of cleaning up the property, even if the current owner did not contribute to the pollution and even if those costs far exceed the property's value. The principal statutes governing these liabilities are the federal "Comprehensive Environmental Response, Compensation, and Liability Act of 1980" ("CERCLA," also known as "Superfund") and various state analogs, usually called state "mini-Superfunds." In terms of underground petroleum storage tanks, cleanup obligations usually arise under the federal "Resource Conservation and Recovery Act" ("RCRA") and, again, its state equivalents.

While there are ways that a current or prospective landowner can avoid liability in some cases (the topic of "Brownfield" exemptions is discussed below), as will be seen these avoidance mechanisms are legally complicated and may afford a less than complete exemption from liability. And if the statute's protections are not obtained, the consequences can be dire: the average Superfund cleanup takes 10 years and costs somewhere between \$30 to \$40 million. In addition to the expense of cleanup, there can also be countless headaches in terms of management distraction, legal and technical involvement, and long-term (or even permanent) requirements for future action or restrictions on permissible uses of the property.

### *Liabilities to Third Parties*

Almost as bad as the cleanup obligations is the range of potential legal liabilities to third parties, the two most common of which are claims for property damage to adjacent properties, and claims for personal injuries for both on-site and off-site persons who may have come in contact with the contamination.

One of the most common assertions by third parties is that contaminated groundwater has migrated from the site and the presence of that underground contamination has reduced the value of this person's property. Where the contaminated groundwater has migrated over some considerable distance, the claims might even be brought as a class action. Personal injury claims, although rarer than property damage claims, also usually arise from contact with contaminated groundwater (recall *A Civil Action* and Erin Brokovich), although exposure to soil and even vapors can also be a risk. Indeed, one of the

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hottest topics in the regulatory arena, which means it may well appear soon in a courtroom near you, has to do with “vapor intrusion,” i.e., the claim that contamination remaining deep underground in soil or groundwater is releasing vapors that migrate upward and into occupied spaces.

The extent to which non-polluting current owners are liable to third parties is complicated. Obviously, plaintiffs’ attorneys will generally follow the money, so any non-penurious landowner will be in the cross hairs, whether or not he is or ought to be liable. Even beyond that, though, there are two potentially legitimate sources of liability even for landowners who did not contaminate the property. First, if a landowner allows a use of property when he knows (or should have known) that there was contamination on the property that rendered it unsuitable for such use, he may be liable on claims of negligence, strict liability, failure to warn, and others. Second, under most state laws, while a person who did not create a nuisance is not liable for abating it, if an “alienee” of a nuisance-causing condition maintains the condition, especially after a request to abate, he can be liable for all future losses associated with the condition.

### ***Difficulties in Selling or Financing Contaminated Property***

Mostly as a result of the two foregoing problems, many sane persons will have nothing to do with contaminated property. As a result, it can be difficult to find a purchaser for contaminated property, which in turn means that (1) the sale price may have to be greatly reduced and (2) lenders may be reluctant to accept the property as collateral, both because of its low value and because they won’t want to foreclose and own it either.

Again, the suite of modern Brownfield laws and other risk-management tools discussed below can address most of these problems, and therefore one will find less reluctance if the buyers or lenders are relatively sophisticated and have good legal counsel. Nevertheless, one still encounters the highly risk-averse party for whom a transaction in contaminated property will face major psychological obstacles. For that reason, even under the best of circumstances, it is important to perform an objective and realistic valuation of the property and the effect of the contamination on resale and financing.

### ***Restrictions on Property Use***

Obviously, certain kinds of contamination are not compatible with certain land uses, such as residential or sensitive commercial uses, such as day care centers. Even after an extensive cleanup, some previously contaminated property may not be suitable for all potential uses. For example, many governmental cleanup standards expressly anticipate a certain land use. So, if a property were cleaned up anticipating that it would be used only for industrial purposes, it might be subject to a less-stringent cleanup standard but, for the same reason, could

never be used for residential purposes. Other forms of restrictions that one might encounter for “cleaned up” property include a restriction on use of groundwater, restrictions on interfering with in-place corrective measures (such as underground barriers), requirements to maintain groundwater treatment systems, and periodic inspection or maintenance obligations. All of these are usually stated in various “restrictive covenants” recorded in the local property offices, but a visit to the governing environmental agency and an inspection of their files is usually necessary to understand the full import of the restrictions.

Even apart from the official restrictions, though, there may be other reasons why one would prudently limit certain uses of currently or previously contaminated property. If deep contamination were left in place, construction practices might be different. If the property has contaminated groundwater, one might inquire, for example, as to whether voluntary restrictions on the property’s use (to avoid vapor intrusion claims) would be appropriate.

## **Addressing the Risks of Contaminated Property Ownership**

Given the formidable range of potential liabilities, one might well decide that there’s simply no good reason to own contaminated property. Actually, though, there can be many good reasons, not the least of which is that such properties can be extremely valuable and the risks can be mitigated. The combination of the two can mean that, if one can keep his wits about him and employ the proper mix of risk-reducing methods, owning contaminated property can be quite profitable. What follows is a short survey of the sorts of risk management methods that are currently available.

### ***Contractual Solutions***

One of the most common, and oftentimes most effective, ways to deal with contaminated property is also one of the oldest: simply allocate the duties and risks associated with the contamination through contractual measures. For example, either in the purchase and sale agreement, or in a host of related side agreements, the seller may make various warranties about the condition of the property, may assume future cleanup obligations, may provide escrow accounts to fund investigations or cleanups, or may undertake any of countless other financial or cleanup obligations. Depending on the sophistication of the parties and their attorneys, negotiating such arrangements can range from moderately easy to darn-near impossible, although as more and more real estate investors and developers gain familiarity with the concepts involved, the process is getting progressively easier. As with all such terms, the parties must be clear about the underlying deal, preferably before the drafting process starts, although it must be acknowledged that it’s often not until the drafting stage that the contours of the deal really take shape.

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There are several issues to keep in mind in dealing with contractual means to address environmental concerns. First, obviously, the contractual rights and duties are only as good as the contract itself and the financial wherewithal that stands behind it. Second, while contractual provisions are generally enforceable between the parties, they are generally not effective against the government (an exception of sorts occurs in various Brownfields contexts).

### ***On-Site Solutions***

Recall that one of the most troubling aspects of dealing with contaminated property is the uncertainty in knowing exactly what one is buying into. For this reason, one way to facilitate a transaction may simply be to remove or quantify the uncertainty. There are several ways this can occur. A common element of due diligence, for example, is the “Phase I Assessment” (which, as explained below, may also be required for “innocent landowner” or “bona fide purchaser” protections). A “Phase I” is just a limited onsite inspection, coupled with a check of available public records, to identify a set of what is called in the trade as “Recognized Environmental Conditions,” such as sites regulated by state or federal agencies, underground storage tanks, asbestos, and the like. Understanding what a Phase I is and is not is extremely important. For the most part, a Phase I will never be adequate for transaction purposes if there are anything other than trivial environmental issues. For example, a Phase I does not include an evaluation of whether site operations comply with environmental laws (a “compliance audit”), or an estimate of the nature and extent of any contamination present on the site (which generally requires a follow-up investigation known as a Phase II), or an estimate of potential cleanup costs.

Going beyond a Phase I, though, can produce a wealth of information that is quite capable of providing information sufficient for a transaction to occur even with substantial environmental issues. For example, we were once able to structure a purchase of a site listed on the “National Priorities List” when, combined with a range of contractual and regulatory assurances, the purchaser was able to delineate the contaminated areas of the property to a high degree of certainty and satisfy itself that the areas of interest were not affected by contamination.

An even more aggressive approach to risk minimization is to actually conduct the cleanup of the property. Obviously, if the contamination has been removed, especially if the cleanup has been sanctioned by the government, the only uncertainty remaining is future regulatory action, a risk that many purchasers are willing to live with, or that can usually be quite easily and inexpensively insured over (see below). A transaction-related cleanup can occur prior to or after consummation of the sale and can be conducted, subject to a detailed set of contractual specifications, either by the seller or the purchaser.

### ***Brownfield Immunities and Other Regulatory Solutions***

During the 1980’s and early 1990’s, the government began to realize that the devastating liabilities it had imposed on owners of contaminated properties were having an unanticipated effect: completely innocent persons, who in no way ought to be subject to the “polluter pays” principle of environmental laws, were so intimidated by environmental liabilities that they were avoiding contaminated properties, often located in urban areas most in need of redevelopment, and locating instead in the suburban sprawl-zone, areas called “greenfields.” As a result, the government began to enact various “brownfield” laws that can immunize purchasers of contaminated property against devastating cleanup liabilities.

While the specific requirements and benefits of federal and state brownfield laws vary widely, there are several common characteristics. First, most brownfield laws establish a category of purchaser, often called an “innocent purchaser” or a “bona fide purchaser.” Under federal law, for example, a “bona fide prospective purchaser” (“BFPP”) is someone who establishes by a “preponderance of the evidence” that he: (1) acquired the property after the contamination had already occurred; (2) made “all appropriate inquiries” into the past uses of the property prior to acquiring it; (3) provides all appropriate notices associated with the contamination located on the property; (4) exercises appropriate care regarding the contamination on the property (which is a thorny issue, but beyond this brief summary); (5) cooperates in any actions to investigate and clean up the property; (6) complies with all land use controls imposed on the property; and (7) has no affiliation with persons responsible for contamination or for cleaning it up. Note that one interesting aspect of BFPP status is that, unlike certain earlier efforts to immunize innocent purchasers, it is not necessary that the purchaser be unaware of the contamination. In addition, it is common that only certain kinds of properties are eligible for brownfield treatment, one of the most common restrictions being that the site is not already subject to a response action by a responsible party.

If one can establish that both the property and the purchaser are otherwise qualified, that purchaser (and often the purchaser’s successors in title) is thereafter exempt from future cleanup obligations related to the pollution in place when the transaction occurred. The main benefit of BFPP status is that it effectively eliminates the risk of government-imposed cleanup obligations. As such, it forms an important, but not sufficient, element of solving the multitude of risks inherent in purchasing and owning contaminated property.

Even without full brownfield immunity, there are other similar sorts of regulatory solutions that can be successfully employed. For example, it is sometimes possible to have properties “delisted” from state action lists, agencies sometimes issue “no further action” letters, and in some cases, agencies still enter into “prospective purchaser agreements,” which have mostly been overtaken by brownfield provisions but are still useful in certain circumstances.



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## *Environmental Insurance*

One of the most important tools in the risk-reduction arsenal is the increasing use of environmental insurance. Environmental insurance is merely one specialized form of casualty insurance, namely one that insures against losses associated with environmental contamination. However, environmental insurance differs in one important respect. While other forms of insurance are based on complex actuarial analyses, environmental coverage tends to be based on site-specific environmental data (although an exception occurs for certain kinds of simple real estate transactions or for multi-property transactions). This fact is important when one considers whether environmental coverage will be available and, if so, at what cost.

While there are many variations of environmental coverage, there are two kinds of environmental insurance that can be important in a brownfield transaction. The first is “cost cap” coverage. Also known as “stop loss,” or “guaranteed fixed price remediation,” the purpose of such coverage is to provide some assurance that the cost of cleaning up known contamination on a parcel will not exceed a specified amount.

For obvious reasons, cost cap coverage is usually available only if site conditions and cleanup requirements are relatively well defined. In addition, because cost cap coverage is so dependent on site conditions and cleanup options, the underwriting effort can be complex and many carriers require payment of a fee to cover underwriting costs. Finally, cost cap coverage lasts only for a relatively short period of time (such as 3 to 5 years), so the prospect of additional cleanup further down the road will need to be separately insured. Having said that, though, in appropriate cases, cost cap coverage is usually reasonably priced and carries relatively few exclusions. Thus, it can provide the kind of comfort required where the risk of a large up-side for cleanup expenses is more than the economics of the deal can support.

The other kind of coverage frequently used for contaminated properties is “pollution legal liability” (“PLL”) coverage. PLL policies can cover both first party liabilities (such as onsite cleanup obligations for undiscovered contamination) and third party coverage (such as bodily injury or property damage for both onsite and offsite exposures). Significantly, it is possible to purchase PLL coverage even for future discoveries of contamination that, even without a government cleanup order, create losses (such as loss of property use or, in some cases, loss of property value) for the property owner. Also included can be business interruption losses, additional construction costs, and coverage for non-owned locations, such as claims tied to off-site disposal locations. As with all insurance coverage, understanding the coverage and exclusions is critical.

Obviously, such insurance coverage can be a powerful tool in addressing property contamination. The problem with insurance coverage, however, is cost. Indeed, since insurance companies are in

the business of making money, one can safely assume that if the insurer expects to make money by insuring the environmental risk associated with a given piece of property, the owner can expect to lose money by insuring that same risk. That is simply the nature of insurance. One purchases insurance not to alter the profitability of a transaction, but to address the risk aversion tendencies of the participants.

## **What Can and Cannot Be Done**

As the foregoing discussion makes clear, no single kind of approach will solve all potential problems associated with contaminated properties. Indeed, while it is true that all potential problems can be dealt with in one way or another, the economics of any particular transaction simply may not permit those solutions to be deployed. Ultimately, a transaction in contaminated property must stand on the underlying economics of the real estate itself. If a deal has a large upside potential, then there should be enough headroom available to address even the most substantial environmental issues. If the deal is marginal on a real estate investment basis, then there simply may not be enough economic surplus to handle anything other than trivial environmental complications.

With that in mind, the following principles should govern any consideration of a transaction involving contaminated property:

- There is no such thing as an “unsolvable” environmental problem. Everything can be addressed given enough time, money, and effort.
- Transactions in contaminated property are driven by the underlying real estate value. The nature and extent of the set of feasible environmental solutions is directly proportional to the profitability of the underlying deal.
- The best business approach to contaminated property is to treat the environmental issues as one would treat any other contingent liability or unavoidable cost. Work the risks and costs into the economic evaluation of the deal just as one would for any other future contingent cost.
- There is no “one size fits all” solution. Even the simplest transaction will require a mix of contractual, regulatory, and informational solutions; many will also benefit from an insurance component.

In all of this, the key to a successful transaction is to keep an open mind, keep the options open, keep your wits about you, and don't run from the problem simply because the word “contamination” occurs somewhere in the prospectus. As Woody Allen once said, “Eighty percent of success is showing up.” ♦

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## **PRACTICAL CHALLENGES IN WATER WITHDRAWAL PERMIT TRANSFERS**

*Continued from page 5*

Society of Civil Engineers' Regulated Riparian Model Water Code provides a framework for identifying reasonable use that is vague enough to be applied broadly but clarifies the aims of reasonable use: necessary for economic and efficient use without waste, without unreasonable injury to other users, and consistent with the public interest (which is further defined as a pervasive goal of sustainable development).

Considering this definition, was it reasonable for The Savannah Group to propose to withdraw water from the Altamaha River and inject it into the Floridan Aquifer in order to claim ground water supply availability at distant locations? Caught by surprise, the State instituted a moratorium on aquifer storage and recovery and eventually claimed that The Savannah Group lacked a reasonable use since they had no customers under contract. Also on the coast, the City of Richmond Hill has claimed that the moratorium on withdrawals from the Floridan Aquifer is illegal, in part because it interferes with reasonable use and that existing users should have their permits modified in order to accommodate additional users.

Beyond these two cases, the reasonableness of a proposed use is rarely challenged. More typically, the argument centers on justification of the need for the quantity proposed for withdrawal. Challenging the quantity needed is actually a healthy exercise of true riparianism – ideally it forces every permit applicant to make due with the minimum amount in order to preserve capacity for other users. However, justification of quantity becomes inseparable from justification of the type of use when a water supply such as the Floridan Aquifer, Chattahoochee River, or Lower Flint River is believed to be virtually exhausted. In these situations, isn't setting priorities for allocation essentially equivalent to narrowly defining reasonable use? Attempting to clarify what reasonable use is for a particular water source seems likely to open the door for more and more arguments on the reasonableness of increasingly narrow types of uses. Perhaps we will see a lawsuit in the near future in metropolitan Atlanta where a party claims that a municipal water supplier's proposed use of water for public distribution is not reasonable if the municipality allows any low priority uses, such as lawn watering.

### **What does reasonable use have to do with permit transfers?**

Essentially permit transfers need only exist when demand for water exceeds the water supply. Otherwise, a prospective water user could simply apply for a permit. Since fair allocation of a scarce resource is difficult, permit trading may be an effective tool for building in

flexibility to regional water management plans. Interaction among potential trading parties provides at least an initial screening of the reasonableness of a proposed use.

The concern among permit transfer opponents is that transfers will be allowed based solely on having a willing seller and buyer. This is only a first step; the test of reasonable use should still be mandatory, so permit transfers should be subjected to regulatory oversight. Transfers involving little or no change in type of use and quantity of use could be subjected to a streamlined review, while significant changes in location, type of use, and quantity might be reviewed as rigorously as an original permit application.

What then do individuals and the public gain from permit transfers? Perhaps the most obvious gain is that a transferee does not have to acquire the actual permitted facility: a prospective carpet manufacturer could acquire a permit from an existing manufacturer without having to buy the existing carpet mill. Thus, a permit transfer potentially provides an incentive for newer more water-efficient users. Additionally, businesses want certainty in their activities. Businesses may be better able to predict their success if they know they can obtain a permit, even one with only a short remaining term, through transfer rather than starting from scratch. These factors further facilitate economic activity by allowing some freedom to accommodate changing needs of the public and private industry, thus building a degree of flexibility and robustness into an otherwise rigid framework of water allocation.

### **Ecosystem reserves: how much water does a crawfish need?**

In order to fairly allocate a limited water supply it is critical to know how much water there is to allocate. Stream gauging, aquifer monitoring and testing, and modeling have allowed accurate prediction of the total volume of water in a system. Much more difficult to accurately determine is how much should be left in the stream or aquifer, essentially an allocation to maintain natural processes. Georgia's water law is fairly quiet on this subject, reflecting its development during times when human use was paramount and the natural environment was something to be subdued, not accommodated. In the last fifteen years, two factors have spurred a major change in policy regarding maintenance of instream flows and groundwater conditions: a renewed interest in protecting the incredible diversity of aquatic species in the southeast; and concern about saltwater intrusion into the Floridan Aquifer. Georgians are recognizing that some water must be reserved for natural processes and not allocated for human use or the water supply eventually may become so degraded that it is diminished or eliminated.

Recognizing the need to maintain natural flow regimes, minimize alteration of aquifer characteristics, and protect the aquatic environ-

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ment is a step in the right direction, but quantifying the amount that must be reserved is difficult. Engineers expect that it ought to be possible to quantify the water needs of an aquatic ecosystem just as it is possible to quantify the water needs of a chemical manufacturing plant. In truth, science cannot provide a precise answer because our knowledge is limited, the ecosystems are dynamic, and it is impossible to foresee all the impacts that may result from altering a stream or aquifer.

Consequently, there is a tendency now to exercise caution in water allocation so that more water remains in streams, the pattern of natural high and low flows is maintained, and aquifer drawdown is minimized. A surface water withdrawal permit in Georgia may now include a requirement that withdrawals not alter the pattern of seasonal high and low streamflows. The state's imposition of moratoria on withdrawals from the Lower Flint River and the Floridan Aquifer is directly due to the desire to understand the environmental impacts of excessive withdrawals in order to avoid permitting such withdrawals.

## Will permit transfers threaten or strengthen ecosystem water reserves?

Dr. Andy Keeler, a natural resource economist formerly with the University of Georgia, pointed out that a major problem in reserving water for natural processes is that, as water demands increase further, various interests will pressure the state to allocate every last drop. Experience tells us that nature usually loses out to human use, so we may expect that today's ecosystem water reserve is tomorrow's power plant cooling water. We regularly hear claims that the Floridan Aquifer moratorium is not scientifically justified because models predict salt water won't reach the aquifer under Savannah for 100 years, so the state must allow additional coastal ground water withdrawals.

Permit transfers might actually allow us to avoid trespassing on ecosystem water reserves. In a fully allocated basin, a prospective user who has the option to seek a permit transfer might choose to do so rather than lobbying for change in the basin's allocation plan, particularly if obtaining such a transfer is easier and/or more certain. Thus, the environmental benefit of allowing permit transfers between private entities might outweigh concerns about permits flowing uphill toward money.

## Conclusion

Transfer of water withdrawal permits cannot be simply painted as good or bad. Conservation groups that are suspicious of the practice raise justifiable concerns about environmental impacts and conversion to a system of prior appropriation of water rights, but may not have seriously considered possible benefits to the environment. Business groups point out potential benefits to economic development but may not have considered either the potential adverse consequences of

permit transfer or that close regulation may actually benefit a permit transfer program. It seems that an effective and enforceable permit transfer program could be developed. However, allowing permit transfers could substantially change Georgia's water law foundation since, in some cases, a permit might be transferred to a non-riparian, thus separating the water withdrawal permit from the riparian right. As Georgians search for improvements and innovation to our system of water management, we must examine our water use habits and consider that many problems could be avoided if we strove to use less water. Unfortunately, we will never conserve water if there are always extraordinary attempts to get more water. ♦

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