

Environmental Law

Guaranteed Cleanup Cost Contracts: A Keystone for Contaminated Property Deals

By Gordon C. Duus

Often the hardest issue to negotiate in a real estate transaction involving a contaminated property is which of the parties has to pay if the actual environmental cleanup costs are much higher than the estimated used by the parties when they negotiated the deal terms. Many deals used to die over this issue either because neither of the parties to the transaction were comfortable accepting the risk or because the purchaser's lender was the uncomfortable one. Now Guaranteed Cleanup Cost Contracts — in which the environmental consultant agrees to complete the cleanup for no more than an agreed upon guaranteed cleanup cost — are used to close many of these deals. If the guaranteed cleanup cost is exceeded, the environmental consultant pays the cost overruns to the extent provided by the Guaranteed Cleanup Cost Contract ("GCCC"). Where cost cap environmental insurance is purchased, an environmental insurance company pays the cost overruns to the extent provided in the policy.

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By laying this risk off on someone who is otherwise not a party to the real estate transaction, it often becomes much easier to get the parties to close. These deals are not easy to close, but much easier than they were before GCCCs.

GCCCs Without Environmental Insurance: GCCCs can be used to help close contaminated property deals regardless of the purchase price or the amount of the guaranteed cleanup cost. For transactions with a lower purchase price or guaranteed cleanup cost, the GCCC may be the only practical way to address the issue so that closing can occur immediately. This is because the parties may be unwilling to pay the cost of environmental insurance or environmental insurance may be unavailable and therefore the only practical way to secure the payment of costs in excess of the guaranteed cleanup cost is to get the consultant to accept the risk.

All of the environmental documents the seller has concerning the contamination on the property are provided to one or more consultants; who review the documents and provide a proposed guaranteed cleanup cost to obtain a regulatory sign-off from the appropriate governmental agency with jurisdiction over the cleanup (e.g. — the New Jersey Department of Environmental Protection). If the amount of information concerning the contamination on the property is not sufficient for

the consultant to provide a guaranteed cleanup cost, they are asked to provide a proposal for whatever additional work they would need to do in order to provide a proposed guaranteed cleanup cost — different consultants require different amounts of information depending upon how risk adverse they are. Some consultants require a governmentally approved cleanup plan in place before they will agree to enter a GCCC, while others simply want enough sampling data so that they can somewhat confidently predict what the governmental agency that will one day oversee the cleanup will require.

A consultant is then selected to do the cleanup, usually on some combination of their skill and experience and having a relatively low guaranteed cleanup cost. A GCCC is then negotiated with the consultant selected whereby the consultant agrees to perform the cleanup of the known contamination for no more than the guaranteed cleanup cost. Typically, the consultant entering the GCCC agrees to cleanup only the known contamination, which is broadly defined to include the entire discharge of contamination of which there is any evidence in the existing sampling data, both its source and the full extent of its migration. Newly discovered discharges of contamination not seen by the consultant in the sampling data before the GCCC was entered are not part of the

consultant's remedial obligation, although environmental insurance can be obtained to cover this risk as discussed below.

Some consultants want the guaranteed cleanup cost to be paid in full no matter what the cleanup actually costs them to perform, while others are willing to be paid on a time and materials basis with the understanding that upon completion of the cleanup the consultant will receive some percentage (e.g. — 50 percent) of the unspent portion of the guaranteed cleanup cost as a bonus. These GCCCs cover a wide range of issues, but most importantly they make it clear that the environmental consultant is liable for all costs to clean up the known contamination in excess of the guaranteed cleanup cost. Of course, often the only security for the environmental consultant's obligations, which may take many years for the consultant to fully perform (e.g. — where there is groundwater contamination), is the financial strength of the environmental consultant. Clearly, that financial strength may change over time and could reduce the security of the property owner for the consultant's performance, so that it needs to be scrutinized at least before entering a GCCC.

GCCC With Environmental Insurance: Environmental insurance is often used either to provide coverage for the discovery of new discharges of contamination (which are excluded from the consultant's remedial obligation under the GCCC) or as a better form of security for the consultant's performance than is provided by the consultant's assets. Typically, the environmental insurance policy can provide two kinds of coverage: Pollution Legal Liability Coverage and Cost Cap Coverage (the names of coverages vary from insurance company to insurance company).

Pollution Legal Liability Coverage: Pollution Legal Liability Coverage ordinarily covers new discoveries of pre-existing contamination during the policy term. This covers what is ordinarily excluded from the consultant's remedial obligation under the

GCCC. Since the time when pre-existing contamination is most likely to be discovered is in the course of cleaning up the known contamination, we strongly recommend purchasing this coverage as it is usually quite affordable.

Pollution Legal Liability Coverage also covers third party lawsuits (i.e. — lawsuits by anyone other than the seller and purchaser of the property) for property damage or bodily injury arising from any pre-existing contamination whether known or not when the policy was purchased. So if groundwater contamination on the property migrates off-site and impacts a neighbor's property, the Pollution Legal Liability Coverage would protect against a lawsuit by the neighbor for property damage or bodily injury. Coverage can be purchased for claims for either new discharges of pollution occurring after the policy is purchased or for business interruption caused by the contamination or its remediation. This coverage is often the key to getting the parties to close, as it covers virtually all of the risks about which a purchaser of contaminated property and its lender are concerned.

Cost Cap Coverage: Cost Cap Coverage generally provides insurance coverage if the cost to cleanup the known contamination exceeds the guaranteed cleanup cost. For as long as the Cost Cap Coverage remains in place, the environmental insurance company is primarily liable for cleanup costs in excess of the guaranteed cleanup cost that must be incurred to obtain the regulatory sign-off from the governmental agency with jurisdiction over the cleanup. There are only a few insurance companies interested in issuing cost cap coverage, as its claims history has often resulted in it being unprofitable.

The guaranteed cleanup cost serves as the deductible that must be exceeded before the insurance company is obligated to provide the Cost Cap Coverage. While this would seem to take the environmental consultant off the risk of such cost overruns, ordinarily the environmental con-

sultant assumes the risk of such overruns once the term of the Cost Cap Coverage has expired and also if the cost of the cleanup exceeds the amount of the Cost Cap Coverage. Since the insurance companies are only willing to provide Cost Cap Coverage for a fairly tight timeframe (e.g. — usually only one year longer than the consultant's estimated time to conduct the cleanup), this motivates the environmental consultant to finish the cleanup before it assumes the risk of all cost overruns in excess of the guaranteed cleanup cost.

In our experience, using the environmental consultants that we recommend, the insurance companies are willing to provide Cost Cap Coverage even where there is no cleanup plan approved by the governmental agency with jurisdiction over the cleanup. There just needs to be enough investigation done for the consultant to have a good handle on the nature and extent of the contamination. It is the consultant's job to convince the insurance company that there is a sound basis for its guaranteed cleanup cost to serve as the deductible for the Cost Cap Coverage.

Using one of the options above can make it much easier to close a transaction involving a contaminated property. In fact, by using a GCCC with both Pollution Legal Liability Coverage and Cost Cap Coverage, and adding the lender to the policy as an insured, we have been able to get many of the large institutional lenders to accept the contaminated property as the sole collateral for a purchase money mortgage. Otherwise, they would never accept the contaminated property as the sole collateral for the loan. And when the GCCC and environmental insurance make both the parties and their lenders comfortable with the risk, the transaction can close immediately. Only time will tell if, and the extent to which, the recent global economic difficulties for insurance companies and banks will change how GCCCs and related environmental insurance will be used to close transactions involving contaminated property. ■