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What's Below the Surface? Don't Hazard a Guess

Managing Environmental Exposures in REIT Transactions

As the United States has slowly recovered from the bursting of the real estate bubble in the late 2000's, the acquisition activity by Real Estate Investment Trusts (REITs) has started to defy the odds. Even with an uptick in interest rates, buying of commercial, office, retail, and industrial properties continued on an upward trend. Many publicly traded REITs that were historically sitting on the sidelines took advantage of the lower lending rates and availability of distressed assets. Newly formed REITs began to compete with larger institutional REITs in acquiring large portfolios of assets that were underperforming either through foreclosures or distressed sales.

However, the rush to acquire large property portfolios being divested by bankrupt firms or those shedding non-core assets has not been immune to hidden environmental problems associated with the properties. Popular classes of REITs such as industrial, hospitality, technology, retail, commercial office, multi-family, and senior housing may all be subject to pollution liability exposures that can result in bodily injury, property damage and remediation claims as well as legal defense expense.

Continued



As REITs rush to retain real estate attorneys, line up lenders, and solicit environmental consultants to complete Phase I Environmental Site Assessments to support transactions and gain market share, there can be a tendency to overlook some not so obvious environmental concerns due to the mere volume and size of the portfolio and/or the timing demands to close the deal. In other words, if some deals look too good, there is a possibility that danger lurks.

One such conundrum is the all-encompassing presence, or hopefully absent statement, in the Phase I ESA conclusion known as the *Recognized Environmental Condition* (REC). For many would-be buyers of properties, the REC satisfies many stakeholders involved in the transaction. Look a little bit deeper into the Phase I ESA report and one may notice that significant data gaps from lack of information or documentation may be present. One commonly overlooked item is lack of a concise picture of the historical uses and previous tenant operations. For many properties, current uses often present a less innocuous exposure than previous activities that may have included heavy industrial activities, chlorinated solvents and chemical use, or removal of former underground storage tanks (USTs). The mere absence of high risk activities in current operations should not provide an immediate sigh of relief, however. In fact, doing a little more homework with regard to historic uses should be common best practice.

Historical Industrial Use and Recognized Environmental Conditions

Many sites with former industrial uses also utilized hazardous chemicals resulting in a high likelihood of spills while in operation. For those with former USTs, it should be noted whether the USTs were removed or closed in place and if any soil or groundwater sampling was performed at the time. The assurance obtained from a formal UST removal closure letter issued by a regulatory agency may meet a consultant's criteria in addressing a potential REC in a Phase I

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One such example would be when a regulatory agency issues a No Further Action (NFA) or closure letter after a "risk-based" screening assessment provides evidence that residual soil or groundwater contamination does not pose a risk to occupants of the site. Agency "comfort" letters may be issued for UST closures or other issues that resulted in hazardous material releases to the environment. Typically, under a risk-based closure, the agency makes an assumption that the site will remain under the current conditions with either structures or impermeable surfaces (concrete and asphalt parking areas and walkways) providing protection from direct contact/exposure to any contaminants remaining in the subsurface. In these cases, closure letters are issued with the understanding that current site uses will remain the same going forward and the subsurface will be left undisturbed. This assumption nevertheless may not coincide with a buyer's plans to redevelop a property or raze existing structures to make room for new construction. Any future redevelopment increases the risk of discovery of residual or possibly new contamination. This often results in unexpected costs to further characterize the site contamination, remediate unknown pollution conditions and/or pursue historical liability with responsible parties.

For property buyers, previous issuance of a regulatory agency closure letter may not always provide the security and assurance that a site is free of contamination and can be developed for unrestricted use. These items should not be overlooked simply because a Phase I ESA did not identify RECs and/or a regulatory closure letter was issued. In some

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cases, closure was achieved so long ago that current cleanup levels have become more stringent. A change in cleanup standards creates a problem if the site is redeveloped or undergoes expansion/renovation and some type of subsurface work is required. This may result in excavation of soil that was presumed to be “clean” being reclassified as industrial or hazardous waste along with unanticipated expenses for special handling and disposal. This may also lead to project delays that extend beyond the term of the bridge or construction loan obtained by the property owner. Ultimately, project delays can also lead to loss of revenue from planned site operations or tenants.

Some specific concerns associated with former USTs include the heating oil or No. 2 fuel oil tanks that were historically used in older buildings. Unfortunately, most States only recently began to regulate fuel oil tanks. For properties where the original building is 40 to 50 years old and changes in the property use have occurred, there is often a lack of documentation from regulatory databases or agency files. Most States did not begin to document or issue permits for USTs until the late 1970s or 1980s. Although some building permits may indicate an UST was installed and issued a permit, information on whether the UST was ever removed may not exist. It may be difficult to ascertain this without a geophysical assessment using a magnetometer survey, soil borings, or test pits.

USTs are not the only culprit that can raise a red flag during proposed real estate acquisitions. Other potential environmental hazards include active or historic oil-water separators, clarifiers, in-ground hydraulic lifts, floor/trench drains, septic systems, dry wells, and sanitary and/or storm water discharge systems. Phase I ESA reports typically identify these features, but do not always classify them as a REC. However, these features present potential areas of contamination especially if there has been a known documented history of manufacturing and industrial site use. Unknown sources of subsurface contamination could be present from accidental spills, illegal dumping of chemicals, or from conveyance lines and piping with poor integrity.

In the absence of a Phase II ESA investigation, unknown pollution conditions may exist because it cannot be confirmed if historic releases occurred. Even when Phase II ESAs are conducted to address potential soil or groundwater contamination, REITs must be aware that investigation scopes may be limited to only address specific Phase I ESA RECs, contaminants, or areas of potential on-site or off-site contamination sources. Phase I and II ESA scopes and findings can be greatly influenced by the risk tolerance of the previous buyer or seller.

Change in Zoning or Planned Use

More recently, REITs have shifted some of their acquisition strategies to incorporate zoning use changes. In particular, there appears to be an increasing trend with converting former commercial and light industrial properties to multi-family residential uses. Due to the tightening credit requirements and increases in single family residential foreclosures, apartment REITs and multi-family residential developers are acquiring vacant commercial/office buildings with plans to convert them to apartments or condominiums. Changes in zoning or end use require a different level of due diligence when compared to other acquisitions.

One example of this exposure is the Silicon Valley near the San Francisco Bay area. Due to downsizing of technology firms from the heights of the late 1990s, many former office, light industrial and R&D buildings have become vacant. Much of this area was agricultural prior to development as business and industrial parks. At the time of their development, there were minimal requirements for sampling especially since historical agricultural use was not considered a potential concern for occupants of commercial buildings. However, a change in zoning from industrial to residential also results in more stringent requirements for both sampling and cleanup levels. If the proposed use is residential, there will be additional requirements to sample for pesticides/herbicides as well as metals associated with historic agricultural use. Furthermore, the sampling results must be compared to the more stringent residential use levels versus commercial/industrial screening levels. For these projects, this represents an increased exposure to lead, arsenic, and possibly other metals for future residents unless remediation or institutional controls are implemented. A Phase I ESA that is conducted for a commercial office building and/or a light industrial building that had no significant history of chemical use may conclude that there are no RECs in connection with the property. In this particular case, any detection of pesticides and metals could require further investigation and remediation prior to the City/County issuing an occupancy permit for residential redevelopment projects.

Off-site Pollution Sources Impacting Your Site

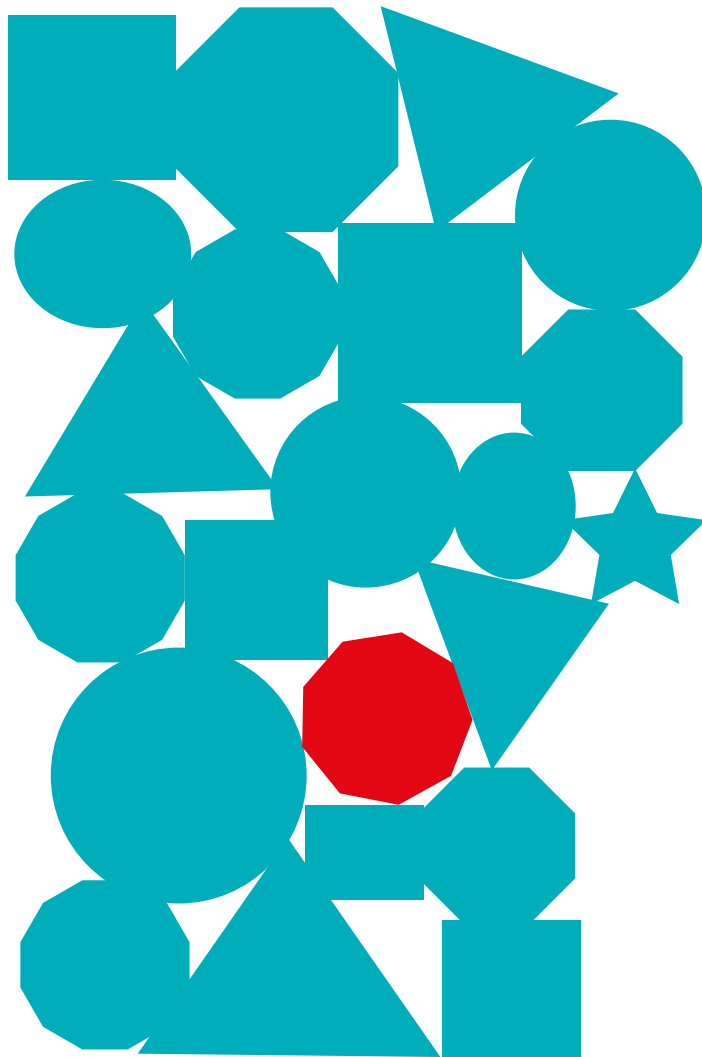
Another frequently overlooked issue includes the potential for adjacent properties with contamination sources to adversely affect a target acquisition site. During the course of acquiring a portfolio of sites, much of the focus of due diligence is associated with potential on-site sources of contamination. Particular attention should also be paid to known upgradient, adjacent, or nearby properties that could be adversely impacting your site. Although an off-site property owner has responsibility for investigation and cleanup of any known contamination, the end result could be the reduction of local property values, third party bodily injury or property damage claims, and associated legal defense expense to establish the liability of a neighboring property owner. It may be prudent to fully evaluate the extent of impact to a property from a known off-site source. This can be particularly important in avoiding legal defense expenses if a REIT's on-site tenants use chemicals similar to those found on site from an off-site contamination source (i.e. chlorinated solvents used by both on-site and off-site dry cleaners).

Another damaging scenario can involve known responsible parties being required to sample soil and groundwater on your property. This creates the potential for discovery of new, unknown chemicals unrelated to the off-site contamination. This can potentially trigger a separate investigation and create new liabilities such as adversely affecting business operations of on-site tenants. This scene has played out where a gasoline retail station property is contiguous to a shopping center. The gasoline station is responsible for a known petroleum hydrocarbon plume that has migrated onto the shopping center and is monitored through on- and off-site wells. However, during the course of routine monitoring of the plume, the gas station owner identifies chemicals such as chlorinated solvents that are unrelated to the gas station operation.

Sale-Leasebacks

According to the National Real Estate Investor (NREI) website, there have been numerous companies in the past that have been in the center of a wave of public offerings under the sale-leaseback arrangement. Some of these companies include Spirit Realty, American Realty Capital Properties (ARC), and Cole Real Estate Investment (recently acquired by ARC). Sale-Leasebacks simply involve a property owner selling a site and then leasing it back from the buyer. The flight to a safer investment has also created a situation where demand for assets under this arrangement has outstripped available assets. Typically, sale-leasebacks are used by companies to raise cash for everything from business expansions to the construction of factories and

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office headquarters. In addition, due to stricter underwriting guidelines for commercial loans, companies now have the option to provide their own alternative sources of financing. The sale-leasebacks occur in many business sectors and can include fast food chain assets, automotive service, office, retail, industrial buildings, drugstores/pharmacies and restaurants. For these transactions, due diligence must still be completed even if current uses don't necessarily involve any significant use of chemicals or hazardous materials.



Particular attention should be paid to any potential historic uses at the site such as former dry cleaners or retail gasoline stations where some form of residual contamination could still be present. In addition, under the leaseback arrangements, agreements with regard to any known historical pollution issues on site should be executed between landlord and lessee so that responsibilities associated with any ongoing monitoring or cleanup are clearly delineated between parties.

An example where unknown contamination could be encountered under a sale-leaseback would be when any expansion to the building or site involves soil excavation. This could be something as simple as new subsurface utility corridors for a slab-on-grade building. In addition, interior tenant improvements could possibly result in discovery of mold issues, lead based paint or asbestos containing materials. This would result in some form of business interruption to the tenant and would be the responsibility of the landlord. Under the sale-leaseback and net lease agreements, the landlord would still be responsible for discovery and abatement of any unknown environmental issues at the site.

Refinancing Surprises

The above-mentioned issues have focused on the potential pitfalls during acquisition of assets. However, existing assets also pose a potential problem to real estate owners and managers. Some properties have been owned by the same firms for over 30 or 40 years. In some cases, properties were acquired before any environmental due diligence or a Phase I ESA was ever required. Problems surface when companies attempt to refinance a loan or use equity from a property that has appreciated to make upgrades or improvements. For some commercial loans, specifically commercial mortgage backed securities (CMBS), a Phase I ESA is required. In the absence of any historical due diligence associated with the property, the report may conclude that there are RECs and recommend additional investigation. This potential scenario is occurring more frequently and resulting in unanticipated site investigation and remediation expense.

Conclusion

The aforementioned environmental liabilities can often be overlooked in real estate transactions. Distressed properties will continue to be acquired by REITs and other real estate management and development companies during a low interest rate environment. According to Commercial Mortgage Alert, there was \$30.3 billion in new CMBS issuance as 2013 drew to a close. This put the CMBS industry on pace to make 2013 the busiest year for CMBS issuance since 2007. Distressed sales are typically accompanied by the need to close escrow in an expedited manner with the least amount of conditions. To reduce conditions and subjectivities for both buyers/sellers, some companies have turned to using environmental insurance as a risk transfer tool to ensure that unexpected environmental issues can be adequately managed. REITs should continue to embrace environmental due diligence and other risk management best practices to minimize future pollution liabilities.

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Contact:

Environmental Team
Office 800 327 1414

505 Eagleview Boulevard, Suite 100
Exton, PA 19341-1120
USA

xlgroup.com/insurance

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