Environmental Liabilities Pose Problems for Real Estate Investment Trusts

Traditionally, real estate markets are dynamic and can pose many perils for investors who are unfamiliar with the intricacies of real estate investing. Real Estate Investment Trusts (REITs) present investors with many advantages — most importantly, professional management of operations. Just as a mutual fund provides investment risk management, so too does the REIT business form. Through aggregation of investor capital, investment liquidity in national securities markets, diversification of real estate holdings — both in kind and region — and professional management, the REIT enables investors to manage risk more effectively than the single real estate investor.

As agents of the REIT, professional management must be constantly acute to their ever-changing business environment. The growth and success of the REIT market is directly attributable to the efforts of professional management who provide attractive returns to REIT investors. As the market evolves, so does the REIT. Recently, REITs have evolved from real estate financiers into active managers of investment properties. This evolution has both rewards and risks. Like all property managers, REIT managers must be aware of economic risks, general liability risks and the unique problems posed by environmental liability risk.

To ensure proactive management of all their business risks, professional REIT managers must ask three questions: (1.) What environmental liability risks do my properties pose? (2.) Can these environmental liability risks affect my bottom line? (3.) What can I do about these risks?

Environmental Liability Posed By Real Estate Properties

By its very nature, real estate is unique. While each property should be individually evaluated, it is possible to get a general idea of environmental problems that may exist within an investment portfolio based on common property uses. When considering environmental issues, it is essential to look at current property uses, as well as past and future uses. Issues to consider include:

Past Property Uses: Location is everything! The value of a property depends to a great extent on its location. Unfortunately, some locations which are attractive for a particular use today were attractive years ago for a much different use. For instance, a tract of land used for years as a remote oil well field may be amidst suburban developments now. Today this land may give a better return if oil production was ceased for residential and retail development. It is important for the developer and subsequent owners of this land to know its former oil well use. After the well pumps have been removed, the former property use will not be readily apparent. Questions may exist on historical issues such as:

- Were the wells correctly abandoned?
- Was oil-stained soil removed or treated?
- Are there any surviving oil or methane gas seeps?

Answers to these questions will determine what risks the land presents. Due diligence prior to the purchase of properties is essential in today’s market to assess the latent environmental issues presented by a property’s history.

Present Property Uses: Most REITs invest in properties with low present use environmental exposure such as office buildings, retail establishments and recreational areas. However benign the use may seem, the potential for environmental exposures still exists. In fact, there are an increasing number of claims by tenants and patrons for incidents such as:

- faulty heating, ventilation, and air conditioning (HVAC) systems;
- poor indoor air quality;
- fuel spills;
- pollutant seepage from the foundation; and
- pollution caused by hostile fire.

Some REITs invest in properties with more than incidental environmental exposures such as chemical product warehouses, industrial facilities and commercial facilities which can pose significant environmental risks from their operations.

Future Property Uses: Environmental liability is more likely when incompatible properties come into contact. For example, a chemical plant is less likely to have complaints from its heavy industrial neighbors than it would from an adjacent residential community. The same rule applies when a property is converted from one use to another. When a REIT divests of a warehouse property, former operations issues are less likely to haunt them in the future if the successor continues warehousing operations. However, if the property is converted to luxury condominiums, it is more likely that environmental problems "passed on" to the successor could be offensive enough to the next tenants to pose future legal problems for the REIT.

Environmental Liability Risks Can Affect Your Company's Bottom Line

A REIT may be either an owner or contingent owner of real estate. There are REITs that directly purchase real estate for the purpose of developing it and/or leasing portions. REITs that provide only financing for real estate purchases are contingent owners who take title to property only upon foreclosure on a mortgage secured by real property. The former REIT has a greater environmental liability risk, but the latter is exposed to diminution of collateral should the property constituting security decline in value as the result of an environmental condition. The primary environmental loss exposures facing REITs are:

- Legal liability for bodily injury and property damage for pollution at a property;
- Cleanup costs for pollution at a property;
- Legal costs for defense of liability claims and government investigations;
- Business interruption loss caused by a pollutant release and cleanup;
- "Soft" costs incurred during a delay in property development caused by pollution; and
- Property value diminution caused by the presence of environmental contaminants.

In the case of environmental liability, the number of incidents affecting companies is relatively low in relation to other business liabilities. However infrequent, when environmental losses occur they are both significant in amount and duration. Environmental cleanups can range from $20,000 to remove a leaking underground storage tank to several million dollars to remediate hazardous waste-containing fill and treat contaminated subsurface waters. Environmental losses, even when precipitated by a sudden occurrence, are not resolved quickly. It may take months to procure the necessary regulatory approvals to initiate and finalize a voluntary cleanup as in the case of an underground storage tank. An environmental toxic tort class action, however, may take years and great amounts of precious business resources to resolve.

In addition to monetary loss for liability claims or cleanup costs, environmental incidents pose other impediments to business operations such as:

- **Financing:** Lender/investor reluctance to accept at-risk property for security
- **Property Transfer:** Discovery of pollution devalues property, hinders development
- **Mergers/Acquisitions:** Environmental matters may stall negotiations

What Can REITs Do About Risks?

There are four typical methods for dealing with environmental risk. Though helpful, the following three methods do present problems:

- **Abate the risk:** Decreasing risk is possible; eliminating it is virtually impossible. For example, a spill may
result despite redundant prevention mechanisms. Latent environmental problems may be discovered at a development site despite an environmental survey performed by a qualified consultant.

- **Assume the risk:** A REIT must be certain of the magnitude of the risk it assumes. Too often an "incidental" risk becomes greater than anticipated. For example, the removal of an old underground tank was expected to cost $20,000. Due to widespread contamination, the actual cost is $200,000.

- **Contractually transfer the risk:** Contractual risk transfer is inherently problematic. The parties may later dispute that a particular loss was transferred, or one party may be unwilling or unable to perform its obligations.

**Insurance: A Viable Solution**

Traditionally, pollution liability caused insurance disputes and stood in the way of real estate deals and other property issues. The legal alternatives were creative, but more often confusing and lacking precedent such as: corporate structure revision, contractual indemnity, escrow and title restrictions. Today, however, there are specialty coverages available in the environmental marketplace that address the unique environmental liability faced by REITs. Insurance solutions are available for:

1. **Legal Liabilities**
   - Tort Liability for Bodily Injury and Property Damage caused by both sudden and gradual pollution
   - Cleanup expenses for remediating pollution discovered at a property
   - Superfund Liability for remote waste disposal
   - Legal Defense Expenses

2. **First Party Loss**
   - Contractual Liabilities incurred due to pollution
   - "Soft" costs incurred during development of property for pollution-caused delays
   - Business Interruption costs
   - Stop-loss protection for planned remediation expenses

3. **Creditor Protection**
   - Reimbursement of principle to Creditors with debts secured by property found to be contaminated

Insurance designed specifically to cover environmental liability alleviates the uncertainties of contracts, the potential for misinterpretation and the financial insecurity associated with warranty or indemnity.

**REITs Can Benefit From Integrated Risk Management**

In addition to specialty coverages, some environmental liability insurers provide an integrated approach to risk management by offering additional property management, redevelopment and transfer services. Typically, these include loss control and risk management services to further reduce the risks and claims management to help contain the costs of liability issues.

Unless REIT managers address the environmental liability issues of their properties, they are not dealing with the complete picture of risk. Fortunately, specialty insurance products are available today that address the unique environmental liability faced by REITs and represent a viable alternative to more traditional and less effective methods of dealing with environmental risk.