

# **MUNICIPAL SETTING DESIGNATIONS AND REDEVELOPMENT STRATEGIES FOR CITIES**

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## I. INTRODUCTION

Many properties across the State are underlain with groundwater that has been naturally degraded or become contaminated by historic industrial and/or agricultural activities in the area. Under current law, a party responding to contamination on property overlying previously degraded groundwater is required to define the full extent of contamination in the groundwater and, in many instances, attempt a costly cleanup of the previously contaminated groundwater.

As a result, significant resources are spent assessing and remediating unusable groundwater and, where resources are limited, cleanup projects that are more critical to the protection of human health cannot be completed. Risk-based corrective action programs have helped reduce these costs somewhat, but the costs associated with delineating groundwater contamination, for example, remain high and often create insurmountable obstacles for the redevelopment of environmentally impaired property.

These prohibitive costs often outweigh the benefits of redevelopment of contaminated properties and, as a result, many urban properties are left abandoned and not returned to productive use. In urban settings, groundwater investigation costs are often significant because numerous historic industrial and agricultural impacts and nature often combine to create ubiquitous groundwater contamination that is practically impossible to “define.” Spending limited resources on the difficult task of delineating urban groundwater is particularly wasteful in situations where that groundwater has no foreseeable use.

This dilemma has led several state legislatures to pass “urban setting” designation bills that recognize this phenomenon and reduce the investigation and remediation requirements under certain circumstances. During the 78<sup>th</sup> Regular Session, the Texas Legislature passed such a reform in HB 3152—the “Municipal Setting Designation (MSD)” Bill.

Used in conjunction with other state and federal tools that afford liability protection, or other

incentives for cleanup of contaminated property, the MSD can be used by landowners or developers alike to reduce the high (and often unnecessary) cost of groundwater investigation and remediation.

An understanding of the MSD legislation will prepare city attorneys for requests that are likely to be brought to cities throughout the State by members of industry and developers seeking to facilitate redevelopment of contaminated sites. The MSD process should also prove advantageous to cities that have properties they own or operate that are facing expensive investigation and cleanup costs. The role that cities play in the MSD process will also create opportunities for cities to improve their bargaining position in many property transactions and enhance economic development activities associated with previously contaminated properties.

This paper starts with a review of the background to the development of this legislation. Next, the legislation will be discussed in detail. Finally, a discussion of redevelopment tools and strategies, which are used to reduce environmental risks, and/or defray the cost of investigation and remediation, will be offered in order to compliment the discussion on MSDs.

## II. BACKGROUND TO THE DEVELOPMENT OF THE MSD LEGISLATION

The obligation to investigate, and ultimately remediate contaminated media, including groundwater, basically arises from four statutory schemes; two at the federal level, and two at the state level.

At the federal level, the Comprehensive Environmental Response and Compensation and Liability Act of 1980 (“CERCLA”) <sup>2</sup> and the Resource Conservation and Recovery Act (“RCRA”) <sup>3</sup> are the fundamental statutes that

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<sup>2</sup> 42 U.S.C. 9601 *et seq.*

<sup>3</sup> 42 U.S.C. 6901 *et seq.*

create the obligation to conduct investigation and remediation activities at sites that have been contaminated.

CERCLA creates a liability scheme that makes certain individuals liable for the cost of investigating and remediating releases of hazardous substances.<sup>4</sup> RCRA, on the other hand, imposes an obligation on owners and operators of hazardous waste treatment, storage, or disposal facilities to remediate contamination of environmental media as a result of releases from solid waste management units at the property.

At the state level, the Texas Solid Waste Disposal Act (“SWDA”)<sup>5</sup> and the Texas Water Code create an obligation on behalf of a responsible person to conduct remedial measures upon contamination of an environmental media.<sup>6</sup>

The liability under these statutes is strict, meaning that a demonstration that the person was at fault is not required—thus, the occurrence of the event, i.e. contamination, is all that is required to render the person liable under these statutory schemes.

As a result of their overall liability schemes, and limited defenses offered, these statutes (especially CERCLA) have been blamed for having a negative effect on the redevelopment of former industrial properties, many of which are in urban settings.

To avoid unexpected costs associated with a contaminated property, prospective purchasers often conduct a due diligence on the property in an effort to determine whether, and perhaps to what extent, the property is contaminated. Of course, faced with incurring liabilities associated with the contaminated site, and incurring large

amounts of costs for the cleanup of contaminated environmental media, once the due diligence revealed the presence of contaminants on the property, prospective purchasers of the property often found it more prudent to walk away from the property rather than to risk the purchase of a contaminated property. The result of this phenomenon was more development of new (“greenfield”) sites and less redevelopment of previously industrialized (“brownfield”) sites.

Ultimately, this trend resulted in large inventories of “brownfield” property in urban areas throughout the country which significantly eroded the local property tax base and created additional problems often associated with abandoned buildings and property.

Beginning in the early 1990s, Congress, EPA, the Texas Legislature, and the TCEQ embarked on a series of reforms targetted at the redevelopment of brownfield properties. Many of those reforms will be discussed in the latter half of this paper. The most recent reform is addressed first.

### **III. THE TEXAS LEGISLATURE’S MOST RECENT BROWNFIELD INITIATIVE – MSDs**

The Texas MSD Bill, HB 3152, was signed into law by Governor Perry on June 20, 2003, and became effective on September 1, 2003.<sup>7</sup> The stated purpose of this new law is the reduction and elimination of groundwater investigations and response actions for certain properties with contaminated groundwater.<sup>8</sup>

The legislation makes two findings: (1) access to and the use of groundwater may need to be restricted to protect public health and welfare where the quality of groundwater presents an actual or potential threat to human health; and (2) an action by any municipality to restrict access to or the use of groundwater in support of

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<sup>4</sup> *Id.* at 9607.

<sup>5</sup> TEX. HEALTH & SAFETY CODE §§361.001 *et seq.*

<sup>6</sup> *See*, for example TEX. WATER CODE §§ 7.031, 26.266, and 26.121 (may cause an obligation to conduct remediation activities in order to stop ongoing discharges/seeps). *See also* TEX. HEALTH & SAFETY CODE 361.271-273.

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<sup>7</sup> TEX. HEALTH & SAFETY CODE, Chapter 361, Subchapter W.

<sup>8</sup> TEX. HEALTH & SAFETY CODE §361.802

or to facilitate a municipal setting designation advances a substantial and legitimate state interest where the quality of groundwater subject to the designation is an actual or potential threat to human health.<sup>9</sup>

These provisions make it clear that the Legislature believes that such designations and the ordinances and zonings that go along with those designations are an appropriate exercise of power by the TCEQ and Texas city governments, respectively.

To further clarify the authority of local governments to take the actions contemplated by the MSD process, key provisions were added to the Local Government Code by the Legislature.<sup>10</sup> While these provisions will not prevent legal authority challenges or takings claims from being alleged, they should go a long way to deter the filing of such claims and improving cities' legal grounds for participating in the MSD process for the legitimate purposes clearly set out in the Legislation.

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<sup>9</sup> *Id.* at §361.8015.

<sup>10</sup> . . . “The governing body of a municipality may regulate: . . .(6) the pumping, extraction, and use of groundwater by persons other than retail public utilities, as defined by Section 13.002, Water Code, for the purpose of preventing the use or contact with groundwater that presents an actual or potential threat to human health.” Local Government Code § 211.003 (a)(6) (Zoning Regulations Generally).

. . . “The governing body of a municipality by ordinance may extend to the extraterritorial jurisdiction of the municipality the application of municipal ordinances adopted under Section 212.002 and other municipal ordinances relating to access to public roads or the pumping, extraction, and use of groundwater by persons other than retail public utilities, as defined by Section 13.002, Water Code, for the purpose of preventing the use or contact with groundwater that presents an actual or potential threat to human health. Local Government Code § 212.003(a) (Extension of Rules to Extraterritorial Jurisdiction)

. . . “For the purpose of establishing and enforcing a municipal setting designation, the governing body of a municipality may regulate the pumping, extraction, or use of groundwater by persons other than retail public utilities, as defined by Section 13.002, Water Code, to prevent the use of or contact with groundwater that presents an actual or potential threat to human health. (b) For the purpose of establishing and enforcing a municipal setting designation, the governing body of a municipality by ordinance may extend to the extraterritorial jurisdiction of the municipality the application of municipal ordinances adopted under this section. Local Government Code § 401.005(a) (Restriction on Pumping, Extraction, or Use of Groundwater).

HB 3152 authorizes the Texas Commission on Environmental Quality (“TCEQ”) to create Municipal Setting Designations (“MSDs”) for specific geographic areas and designated groundwater. Once an applicant can establish that the site is eligible, groundwater use has been appropriately restricted by the relevant municipality, and other specified parties are supportive of the designation,<sup>11</sup> TCEQ is empowered to certify the area as an MSD. As a result of the designation, a party conducting a response action on property within the designated area would no longer have to conduct an investigation or cleanup based on the assumption that the designated groundwater will be used in a way outlawed by the municipality in question.

A site is eligible to be designated as a municipal setting, if the property or properties are located within a city of at least 20,000 residents, an alternative public drinking water supply is available, and the property is subject to a municipal ordinance or resolution (coupled with a restrictive covenant) appropriately restricts

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<sup>11</sup> The following entities are entitled to notice of and comment on the proposed designation:

- Each municipality(ies) that contains the property for which designation is sought;
- Each municipality(ies) located within ½ mile of the proposed designated property;
- Each municipality(ies) that own or operates a water supply well within 5 miles of the proposed designated area;
- Each retail public utility that owns or operates water supply well within 5 miles of the proposed designated area; and
- Each registered private well owner with a well within 5 miles of the proposed designated property.

The first four categories of notice recipients are given effective veto power over the designation because an applicant cannot obtain a designation if an ordinance or resolution, depending upon the circumstances, has not been received from the governing bodies in support of the proposed designation.

other uses of groundwater from beneath the property. The Executive Director of the TCEQ has ultimate discretion in granting a designation, but must deny an application if the MSD would negatively impact the current and future regional water resource needs or obligations of the area or surrounding area where the MSD is sought. Those types of issues are likely to be brought to light by the many parties entitled to notice of, comment on, and, in some cases, veto the proposed designation.

The MSD legislation has the potential to fundamentally change the requirements for investigation and cleanup of contaminated groundwater that have been established by the TCEQ's risk-based cleanup programs over the years. Most importantly, the MSD applicant may no longer be required to consider ingestion of groundwater as a complete pathway, and thus may be excluded as a risk factor. Considering that the ingestion of groundwater is often the driving force behind the investigation and cleanup of groundwater, there is a great amount of incentive to pursue an MSD.

#### **IV. OTHER MEANS OF REDUCING RISKS AND/OR DEFRAIVING COSTS**

##### **(A) Reducing Risks**

There are various methods available to reduce risks associated with a contaminated site to preserve the viability of the property acquisition. Conveying a basic understanding of the available tools and the necessary steps to best utilize those tools is the subject of this section.

The following four sets of tools will be discussed:

- (1) Defenses to Liability;
- (2) Statutory Immunities;
- (3) Exclusions from Liability;
- (4) Shifting Risk Through Contractual Provisions and Environmental Insurance; and

##### 1. Defenses to Liability

The first set of tools available to help reduce environmental risk includes the various defenses to liability that exist under State and Federal Superfund laws.

In 2002, Congress passed the Small Business Liability Relief and Brownfields Revitalization Act (the "Brownfields Act")<sup>12</sup> which provides key clarifications regarding certain defenses and makes available significant additional funding for both the investigation and cleanup of brownfields sites.

On January 11, 2002, the Brownfields Act was passed. The Brownfields Act modifies CERCLA to encourage brownfields redevelopment by providing liability relief to certain qualified individuals, and by providing funding to state brownfield programs and to local governments who seek to return contaminated properties to productive use.

Title II of the Brownfields Act codified certain defenses to CERCLA liability for current owners of property contaminated with hazardous substances. These defenses included the innocent landowner, bona fide prospective purchaser and contiguous property owner defenses.<sup>13</sup> All of these defenses require, at minimum, that due diligence be performed as discussed further below.

##### (a) Innocent Landowner Defense

The innocent landowner defense, as previously discussed, allows a purchaser of property to be eligible for the third party defense notwithstanding the real estate contractual relationship with the person that is a responsible party under CERCLA. This defense is available only if the person undertook "all appropriate

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<sup>12</sup> P.L. No. 107-118, 115 Stat. 2356.

<sup>13</sup> The Brownfields Act does not provide protection for a bona fide prospective purchaser, innocent landowner, or contiguous property owner from EPA actions brought under RCRA 7003, citizen suits brought under RCRA 7002, and RCRA corrective action orders.

inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice in an effort to minimize liability,” and did not know or have reason to know of the presence of the hazardous substances.<sup>14</sup>

The Brownfields Act establishes standards for what constitutes “all appropriate inquiry,”<sup>15</sup> which are discussed at length in the next section of this paper. According to the Brownfields Act, a person must not only conduct a due diligence under criteria established under the Brownfields Act,<sup>16</sup> but must also take “reasonable steps” to stop any continuing release, prevent any threatened future release, and prevent or limit any human, environmental or natural resource exposure to any previously released hazardous substance.<sup>17</sup>

The Brownfields Act also created obligations that a purchaser must comply with after the purchase of the property to preserve its status as an innocent owner. The continuing obligations include:

- Cooperate, assist, and provide access to persons who are authorized to conduct response actions or natural resource restoration at the property.
- Comply with any land-use restrictions established or relied on in connection with the response action at a vessel or facility and not impede the effectiveness or integrity of any institutional control employed at the vessel or facility in connection with a response action.
- Provide access to persons authorized to conduct response actions at the facility to operate, maintain or otherwise ensure the integrity of land-use controls that may be a part of a response action.

- Take reasonable steps to stop any continuing release, prevent any future release, and prevent or limit any human, environmental, or natural resources exposure to previously released hazardous substances.<sup>18</sup>

Thus, a person may qualify for the innocent landowner defense up-front, but must still take steps *after* taking title to remain qualified for the defense.

#### (b) Bona Fide Prospective Purchaser Defense

As noted above, prior to the Brownfields Act, the dilemma of the prospective purchaser was this: for a landowner to successfully assert the innocent landowner defense, it had to demonstrate that he did not know, nor have reason to know that the property was contaminated. Brownfields sites are by definition contaminated, thus, this defense was of no use to a prospective purchaser who wanted to redevelop a brownfields site. Because no statutory defenses were available to the prospective purchaser, the transaction would often stall.<sup>19</sup>

To remove this hurdle, the Brownfields Act created the bona fide prospective purchaser (“BFPP”) defense. According to this defense, a

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<sup>14</sup> 42 U.S.C. 9601(35).

<sup>15</sup> 42 U.S.C. 9601(35) (B).

<sup>16</sup> 42 U.S.C. 9601(35)(B)(ii) and (iv).

<sup>17</sup> 42 U.S.C. 9601(35)(i)(II).

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<sup>18</sup> 42 U.S.C. 9601(35) (B).

<sup>19</sup> In practice, the EPA afforded a defense to prospective purchasers by means of a Prospective Purchase Agreement (“PPA”). The PPA contained a covenant not sue under CERCLA in favor of the prospective purchaser, and provided protection against third party contribution actions, if certain conditions were met. See “Guidance on Settlements with Prospective Purchasers of Contaminated Property.” 60 Fed. Reg. 34,732 July 3, 1995. These PPAs were subject to public comment, and were heavily scrutinized by the EPA. This resulted in significant transaction costs and delays, which served as deterrents to prospective purchasers.

landowner can knowingly acquire contaminated real property and avoid CERCLA liability.<sup>20</sup>

To successfully assert this defense, the BFPP must be able to demonstrate the following:

- All disposal of hazardous substances occurred before the purchaser acquired the facility.
- The purchaser conducted “all appropriate inquiry.”
- The purchaser provided all legally required notices with respect to the discovery or release of any hazardous substances.
- The purchaser took appropriate care by taking reasonable steps to stop any continuing release, prevent any threatened future release, and prevent or limit human, environmental, or natural resource exposure to any previously released hazardous substance.
- The purchaser provided full cooperation, assistance, and access to persons conducting response actions.
- The purchaser complied with land use restrictions that are part of the response action and does not impede the effectiveness or integrity of any institutional control used at the sites
- The purchaser complies with any request for information or administrative subpoena issued under CERCLA.

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<sup>20</sup> The Brownfields Act creates a windfall lien in favor of the EPA for property owned by the BFPP. 42 U.S.C. 9607(r). The lien becomes effective when EPA incurs response costs or when it notifies the owner of its potential liability, whichever is later, however, the lien is subject to the rights of holders of previously perfected security interests. *Id.* at 9607(1)(2) and (3).

- The purchaser established that it is not a liable party or affiliated with any other potentially liable parties through any direct or indirect familial relationship, any contractual or corporate relationship, or as a result of a reorganization of a business entity that as a potentially liable party.<sup>21</sup>

Similar to the innocent landowner defense, however, the BFPP defense requires overcoming certain hurdles and complying with continuing obligations in order to remain qualified for the defense.

For example, the BFPP will have to exercise “appropriate care” to “take reasonable steps” to stop existing releases and prevent any threatened future releases. These requirements are in addition to taking “all appropriate inquiry” and are, in fact, *after* the buyer takes title to the land. Thus, it is obvious that under the current scheme, a due diligence is only half the story. The continuing obligations created by the statute are the other half of the story, and they are vaguely defined in the statute.<sup>22</sup>

The continuing obligations of the landowner after taking title are important to understand (if at all possible) in order to maintain the liability defense and reduce environmental risks, and are, therefore, discussed at greater length in Section III of this article which addresses how to reduce the environmental risks associated with a given property.

#### (c) Contiguous Property Owner Defense

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<sup>21</sup> 42 U.S.C. 9601(40).

<sup>22</sup> On March 6, 2003, the EPA issued the Interim Guidance Regarding Criteria Landowners Must Meet In Order to Qualify for Bona Fide Prospective Purchaser, Contiguous Property Owner, or Innocent Landowner Limitations on CERCLA Liability (Common Elements Guidance). This document set out to clarify the criteria created under the Brownfields Act to qualify, and remain qualified for the landowner defenses, but it leaves many questions unanswered.

Prior to the Brownfields Act, a liberal interpretation of CERCLA exposed to liability an owner of property contaminated by the subsurface migration of contamination from an off-site source. This theory of liability was based on the fact that CERCLA defines the term “facility” to include any area where there are hazardous substances. As such, any property owner that sits on property contaminated by hazardous substances, even if those substances migrated onto their property from an adjoining parcel, could arguably be held liable under CERCLA.

In 1995 EPA published the Contaminated Aquifers Policy (the “Aquifers Policy”),<sup>23</sup> which provided that such contiguous property owners would not be pursued for the cost of contamination as a result of the migration. The Aquifers Policy set out eligibility requirements that found their basis in the third-party defense articulated in CERCLA. There were, however, no affirmative obligations on the part of the property owner to qualify for this “defense.”

The Brownfields Act codified most of the elements of the 1995 Aquifers Policy. The defense, in short, provides that a person owning property that is contiguous to a contaminated site, and that is or may be contaminated by a release or threatened release of a hazardous substance from that contaminated site, is not liable under CERCLA solely by the reason of the contamination, if it can satisfy certain requirements. The requirements are essentially those which are set out in the BFPP discussion, above.

The fact that affirmative obligations are contained within these eligibility requirements (i.e. taking reasonable<sup>24</sup> steps to stop any

releases, or complying with land use restrictions among others) has prompted many, including this author, to suggest that the Act may have inadvertently expanded the liability risks of the contiguous property owner beyond the practical risks that existed before the Brownfields Act.<sup>25</sup>

The first lesson to be learned from the above discussion regarding the various defenses is that conducting “all appropriate inquiry” is required for all three defenses. Thus, the importance of a proper environmental site assessment is evident. The next lesson is that there are now certain continuing obligations on behalf of the property owner that need to be maintained in order to remain qualified for the defenses. These continuing obligations include:

- Complying with land-use restrictions;
- Taking “reasonable steps” for hazardous substances affecting the property;
- Complying with information requests;
- Cooperating and providing assistance or access to parties implementing remedies; and
- Providing all required notices.

There is more to these requirements than might first meet the eye. On March 6, 2003, the EPA issued the Interim Guidance Regarding Criteria Landowners Must Meet In Order to Qualify for Bona Fide Prospective Purchaser, Contiguous Property Owner, or Innocent Landowner Limitations on CERCLA Liability (referred to as the “Common Elements Guidance” because of the common elements present in all three of the defenses). This document set out to clarify the

existent in the contiguous property owner defense provisions. Exactly what this omission means is unclear.

<sup>25</sup> Note that this possible practical expansion of liability risk under federal law does not carry over to the broad protection of contiguous landowners that exists under the Texas Innocent Owner/Operator defense, discussed further in Section III of the paper.

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<sup>23</sup> Policy Towards Owners of Property Containing Contaminated Aquifers, 60 Fed. Reg. 34, July 3, 1995.

<sup>24</sup> Note that unlike the BFPP requirement, which provides that the purchaser must exercise “appropriate care...by taking reasonable steps,” the contiguous property owner defense merely states that the person must take “reasonable steps to....” In other words, the “appropriate care” language is non-

criteria created under the Brownfields Act to qualify, and remain qualified for the landowner defenses, but it leaves many questions unanswered. For example, it is still not quite clear what exactly the phrase “taking reasonable steps” entails since, as EPA acknowledges in the Common Elements Guidance, it is often a fact- and site-specific inquiry. Another example of the uncertainties created by the continuing obligations relates to notices. As the reader may be aware, state and federal laws requiring notice are numerous, overlapping, and often subject to interpretation. Yet there is not an exception for immaterial or technical failures to provide notice and “substantial compliance” is not recognized in the statute. Therefore, it is not clear whether an immaterial notice defect will disqualify you from a defense.

There are numerous other issues not mentioned here that are raised by the vagueness of the continuing obligations language in the Brownfields Act and in the Common Elements Guidance. The point here is that careful consideration should be given to these issues by a BFPP, innocent landowner, or contiguous property owner in order to avoid unintentionally losing its immunity from CERCLA liability *after* acquiring title of the property.

## 2. Statutory Immunities

In addition to the statutory defenses under federal Superfund laws that can be secured through proper assessment and follow-up, there are a few immunities from liability available under state law that can help significantly reduce risks associated with environmentally impaired property. In Texas, the key statutory immunities that fall into this category are found within the Texas Voluntary Cleanup Program (VCP) and the Texas Innocent Owner/Operator Program (IOP).

### a. Texas Voluntary Cleanup Program

In 1995, the Texas legislature enacted the statute authorizing the Voluntary Cleanup Program

(“VCP”).<sup>26</sup> The VCP was designed to encourage parties to voluntarily conduct investigation and remediation activities on their properties. The VCP accomplishes this goal by providing incentives to remediate property by removing liability of lenders and future landowner.<sup>27</sup> The VCP was also intended to assist the owner of impacted property to address the contamination on his property more promptly than might be the case if the party was going through the Corrective Action of the Texas Commission on Environmental Quality (“TCEQ”).<sup>28</sup>

Upon meeting the eligibility criteria for entering into the VCP, which basically includes any site except those that are subject to TCEQ permit or order,<sup>29</sup> payment of a \$1,000 application fee, and entering into a voluntary cleanup agreement,<sup>30</sup> a party may enter into the VCP.<sup>31</sup> After

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<sup>26</sup> TEX. HEALTH & SAFETY CODE 361.601 *et. seq.* Regulations promulgated pursuant to this statute are contained in 30 TEX. ADMIN. CODE Chapter 333, Subchapter A.

<sup>27</sup> *Id.* at 361.602.

<sup>28</sup> Whether the VCP has been successful in accomplishing this latter task is debatable given the backlog that has developed in the VCP.

<sup>29</sup> *Id.* at 361.603.

<sup>30</sup> *Id.* See also *Id.* at 361.606.

<sup>31</sup> Most contaminated property is eligible for the Texas VCP, except for the following:

- The portion of any site that is subject to a TCEQ permit or order or subject to response actions under the jurisdiction of the Texas Railroad Commission;
- A site either proposed for, or already placed on, the National Priorities List (NPL);
- Hazardous waste facilities operating under a RCRA permit, interim status permit, or those that have been issued a RCRA Section 3008(h) interim status corrective action order;
- A site where an administrative, state, or federal enforcement action is pending that concerns the remediation of the hazardous substance or contaminant described in the VCP application;
- A site where a federal grant requires an enforcement action;

completion of the TCEQ-directed cleanup, the TCEQ will issue a certificate of completion,<sup>32</sup> which essentially states that all non-responsible parties are released from all liability to the state for areas that were addressed by the certificate.

The VCP affords the seller an opportunity to make his property more marketable by providing for liability waiver from state enforcement actions for the purchaser of the property.<sup>33</sup> Since the non-responsible parties (including the purchaser and future owners) receive protection from liability from the State, many of the barriers to consummating a real estate transaction are lifted and thus, redevelopment becomes more likely.

As a practical matter, the VCP allows a person to place a site into the VCP and transfer ownership of the property before cleanup is completed.<sup>34</sup> So long as the cleanup is completed as specified in the VCP agreement, a buyer may take over the property and have the certificate of completion issued to protect the buyer as if the certificate had been issued before the purchase.<sup>35</sup>

This is particularly useful if the seller is willing and able to provide some indemnification to a redeveloper who is willing to accept the risk of delay if additional problems are encountered. This is also a particularly useful tool when groundwater contamination is involved that will take a number of years to fully remediate. Surface redevelopment can move ahead with

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- A site where all costs recoverable under the State Superfund are not paid in full by the applicant.

<sup>32</sup> A certificate of completion is essentially a sign-off by the TCEQ on all the contaminants on-site for the area covered under the certificate.

<sup>33</sup> While the liability waiver applies to the purchaser, not the owner, the owner of the property is free from TCEQ enforcement action as long as he is in the VCP and complying with the VCP agreement.

<sup>34</sup> In order to be eligible for such a “back-dated” liability waiver, the purchaser of the property must be a co-applicant on the VCP application prior to taking title to the property.

<sup>35</sup> TEX. HEALTH & SAFETY CODE §361.610.

reduced financial risk to the developer and lenders while groundwater remediation might continue for years without impacting the surface development.

In circumstances where the purchaser is not a co-applicant and it is feasible to obtain a “conditional” certificate of completion prior to taking title to the property, a purchaser may still take title of the property and later receive immunity from liability effective from the date of the conditional certificate of completion if a final certificate of completion is ultimately issued.<sup>36</sup>

b. Texas Innocent Owner/Operator Program

Another statutory immunity from liability that can reduce risks, facilitate transactions, and even resolve disputes with adjacent property owners is found in the Innocent Owner/Operator Program (“IOP”). The IOP was enacted in 1997, two years after the VCP was enacted.<sup>37</sup>

The IOP affords protection from liability for contamination that originated off-site on adjacent properties, but migrated onto the “innocent owner/operator's” property. The innocent owner/operator can obtain a certificate from the TCEQ documenting his innocent status. Although the immunity will apply in the absence of an IOP certificate, it is generally advisable to obtain a certificate in order to confirm that the TCEQ acknowledges the applicability of the immunity.

In contrast to the Contiguous Property Owner Defense discussed above, it is not generally a prerequisite that the owner asserting the defense purchased the property without knowledge of the contamination after conducting an environmental due diligence investigation. In fact, the only situation where it is a prerequisite of the IOP immunity to have no knowledge of

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<sup>36</sup> *Id.* and 30 TEX.ADMIN.CODE § 333.10.

<sup>37</sup> TEX. HEALTH & SAFETY CODE §361.751 *et seq.*; *see also* 30 TEX. ADMIN. CODE Chapter 333, Subchapter B.

the contamination after conducting a pre-purchase investigation of the property is when the property in question was a portion of a tract containing the source of contamination and the property is purchased from a person who caused the release. In such a situation, the person must demonstrate that after “appropriate inquiry consistent with good commercial or customary practice, he did not know or have reason to know of the contamination on the property at the time of the purchase.

It is important to note that changes in the federal standard of “all appropriate inquiry,” brought about by the Brownfields Act and the ensuing AAI rulemaking process, will have a practical impact in Texas because the TCEQ is likely to follow the federal precedent (based on comments made to the author by TCEQ legal staff).

### 3. Exclusions From Liability

The next set of tools worth noting that can help reduce environmental risks in redevelopment projects is a group of exclusions from liability that exist for lenders, fiduciaries, and others involved in certain financing arrangements.

For the most part, lenders have three concerns when it comes to brownfields redevelopment: (1) proper estimation of the market value of the property, (2) retaining the value of the property which is held as collateral; and (3) being held liable as an “owner” because it holds title to collateral, or being held liable as an “operator” because it takes actions it deems necessary to protect the value of its collateral or to foreclose on that collateral. This section addresses the third concern.

The Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 (the “Lender Liability Act”)<sup>38</sup> provides protection to lenders (including banks, individuals who make loans to nonaffiliated persons, and loan guarantors) from liability under CERCLA as long as they do not “participate in management”

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<sup>38</sup> See 42 U.S.C. 9601(20)

of the facility on which they hold a loan. Lenders also are exempt from liability if they did not “participate in management” of a facility on which they subsequently foreclose and then make timely, commercially reasonable efforts to sell, re-lease or otherwise divest. The mere capacity to influence, or the unexercised right to control, operations of a facility do not confer liability on the lender. Rather, to be found liable, while the borrower is still in possession, the lender would have to exercise decisionmaking control over the facility's environmental compliance or otherwise exercise substantial control over all of the facility's operations.

As for fiduciaries (which include most parties who act as trustees, executors and administrators)<sup>39</sup> they are protected from personal liability unless they are negligent or they cause or contribute to the contamination. In most circumstances, a fiduciary's liability will not exceed the assets held in the fiduciary capacity.

The state law mirrors the federal requirements with respect to lender and fiduciary liability.<sup>40</sup> Note that both the state and federal lender liability protections extend to most lease-finance transactions.<sup>41</sup> The applicability of these provisions to lease-finance arrangements creates significant opportunities for cities or other entities that may desire to act as a conduit for economic development funds to a redevelopment project but are required to hold title to the property to qualify for funding. In those situations, the city or other grant recipient could hold title solely as a security interest via a lease-finance transaction in which the redeveloping party is the lessee who will ultimately take title to the property after satisfying the terms of the lease-finance arrangement. Because, with very limited exceptions, such a transaction fits within the

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<sup>39</sup> *Id.* at §9607(n).

<sup>40</sup> TEX. HEALTH & SAFETY CODE, Chapter 361, Subchapters T and U.

<sup>41</sup> See definition of “extension of credit” at TEX. HEALTH & SAFETY CODE §361.701(1). & 42 USC § 9601(20)(G)(i).

statutory definition of “extension of credit,” the exclusion of liability can apply and protect city or other grant recipient from superfund liability. In the right circumstances, this can be a very powerful brownfield redevelopment tool.

#### 4. Devices for Shifting Environmental Risk

The next set of tools to be discussed is the variety of contractual devices and insurance products that can be used to help shift the risks associated with environmental conditions at a given property.

##### a. Contractual Provisions

The most direct way to shift environmental risk is through the use of contractual provisions in the real estate agreement governing the conveyance of the property in question. A disclaimer that goes without saying but is worth reiterating is that contractual provisions shift risk only to the extent that the other party in the transaction has the financial resources to cover the costs that might arise from those risks.

##### Representations & Warranties

Typically, in a real estate acquisition, the seller makes contractual representations and warranties that form the groundwork for the transaction. Representations and warranties may relate to a number of topics, which often include the environmental condition of the subject property. Exactly how the representation and warranty provisions are worded is an issue between the parties and often negotiable. For example, the representation and warranty provision may state that the property is in full compliance with all environmental laws and regulations (a provision desired by the purchaser of the property), or it may be limited to “the best of the seller’s knowledge” or even “to the best of the seller’s knowledge after independent inquiry.” Whatever the case may be, the buyer relies upon these statements to finalize the transaction. If properly applied, these provisions can serve as effective tools in allocating environmental risks.

##### Indemnification

The most common mechanism for allocating environmental risk is an indemnification covering breach of representations and warranties, as well as damages relating to assumed liabilities. An indemnification provision is essentially a commitment by the indemnitor to protect the indemnitee from third-party claims and/or other assumed liabilities. As pointed out at the beginning of this section, the value of the indemnification provisions is limited by the financial resources of the indemnitor.

##### Escrow

Often parties are motivated to finalize a transaction before the environmental conditions have been addressed. In such situations, the parties may decide to place a portion of the sale proceeds in escrow to be used for site remediation purposes or for the purpose of securing the indemnity clause of the contract.

##### b. Environmental Insurance

Traditional contractual tools that allocate risk in transactions, including representations and warranties and indemnification clauses do not always adequately shift environmental risk. This is due to the fact that they are limited by the financial resources of the other party, and because they are not designed to account for unforeseen costs.

Environmental insurance can be used to address a variety of environmental risks, ranging from unanticipated cleanup costs to unforeseen liability. Like all other forms of insurance, risk is transferred from one to another for a fee.

Coverage is now available to insure every party and many aspects of a redevelopment project. Environmental insurance removes the numerous uncertainties that can hinder redevelopment of contaminated properties

The insurance industry has gradually developed a broad range of risk-specific environmental insurance products in an attempt to meet the

needs of those seeking to define and limit their exposure from known and unknown environmental conditions.

There are six major classes of environmental insurance that relate to risk management at contaminated sites. These include:

- Pollution Liability Policies
- Cost Cap Policies
- Secured Lender Policies
- Environmental Remediation Insurance & Property Transfer (Finite Policies)
- Mortgage Impairment Insurance
- Brownfields Insurance

These insurance policies can be tailored to specific situations and, particularly when used in conjunction with more traditional risk shifting tools, can be very useful in transferring certain types of environmental risks.

#### Pollution Legal Liability (“PLL”) Policies

These policies cover developers and long-term owners of redeveloped brownfields, up to specified amounts, in the event that users of those properties make claims based on continuing pollution conditions. As a general rule, these policies provide coverage for three general types of risks: third party bodily injury and property damage tort liability claims; costs of any remediation and other related expenses; and legal defense costs associated with the first two risks.

#### Cost Cap Policies

Cost Cap policies, also referred to as Cost Overrun policies, provide the developer with protection against the possibility that actual cleanup costs exceed original estimates.

The premiums and deductibles of these policies are usually quoted as a percentage of the estimated cleanup cost. This kind of coverage has historically been quite expensive as has only been cost-effective for cleanups that exceed \$5 million. For projects smaller than \$5 million, self insurance against overrun has typically been

preferred. These policies have particular application for redevelopment of a portfolio of sites in a project.

#### Secured Lender Policies

These policies are designed to benefit the financiers behind the brownfields redevelopers by guaranteeing loan repayments in the event that a borrower defaults on loan payments, or if collateral value is lost due to environmental conditions.

Developers should note that these policies do not protect them from any risk, but rather only limit the lenders’ risks by providing reimbursement to a lender. As such, these policies are usually combined with other forms of coverage to protect developers in redevelopment projects.

#### Environmental Remediation Insurance & Property Transfer

These policies are designed to protect either the buyer or the seller from unknown or undiscovered pollution incidents occurring prior to the sale of a designated property. Coverage is provided for third-party bodily injury, property damage and clean-up costs.

#### Mortgage Impairment Insurance

Mortgage Impairment is a securitization collateral protection that addresses the special needs of loan originators, and investors who participate in the commercial mortgage-backed securities market. These policies will pay the insured the lesser of either the outstanding loan balance or the estimated cleanup costs due to contamination on the real estate collateral in the event of a default on the mortgage. Generally, first-party cleanup cost coverage is provided for claims made after foreclosure, and coverage is provided for third-party bodily injury and property damage claims, including defense costs. These policies are relatively inexpensive when compared to other environmental insurance instruments and can help secure financing for speculative Brownfield redevelopment projects.

## Brownfield Insurance

When considering investment backed brownfield redevelopment, two major concerns must be managed. First, the extent and cost of remediation must be managed and tailored to the proposed site reuse and regulatory requirements. This is a major concern for the potential buyer because the strategy is typically to purchase a brownfield inexpensively, clean it up, redevelop the location, and sell or lease the property for a profit. The cost of remediation is often the key to the financial viability of the development. The second consideration is the third party environmental liability resulting from ownership of a property where contamination is being or has been remediated.

Some insurers are combining cost cap insurance and pollution legal liability policies into a brownfields insurance package specifically for distressed property redevelopment. First, party pollution cleanup coverage for known conditions is provided through a cost cap policy, allowing the insured to bring certainty to the ultimate cleanup costs. Cleanup of unknown pre-existing conditions as well as third party liability coverages are provided by the PLL policy. Some insurers will write the PLL so as to include coverage for continuing expenses (“soft costs”) and loss of income due to project delays caused by discovery of unknown conditions.

### **(B) Defraying the Costs of Environmental Investigation and Remediation**

This final section of the paper contains a discussion on several types of funding, technical assistance, and tax incentives that can help to defray costs associated with a site that has been identified to contain contaminants.

#### 1. Federal Brownfield Grants

Several funding mechanisms can be used to help redevelop brownfields sites. Some of the more commonly used mechanisms are detailed below. This is by no means a comprehensive list of available funding as there are numerous sources of funds available to a developer that may or may not specifically be dedicated for use at

brownfields sites, but may provide a good means of additional funding.<sup>42</sup>

#### (a) Targeted Brownfield Assessments (“TBA”) Grants

EPA’s TBA program<sup>43</sup> is offered to eligible entities<sup>44</sup> to address brownfields sites. A Targeted Brownfields Assessment may be used for assessment and the establishment of cleanup options and cost estimates based on future uses and redevelopment plans.

The TBA program is managed through the EPA Regional offices and they have discretion in selecting areas to target for site assessment assistance. As a general matter, the Regional offices select sites that are abandoned or publicly owned; have low to moderate contamination; include issues of environmental justice; suffer from the stigma of liability; or have a prospective purchaser willing to buy and pay for the cleanup of the property, if needed.

TBA’s are conducted by environmental consultants already under contract with EPA. The value of these grants is usually \$50,000.

#### (b) Brownfield Assessment, Revolving Loan Fund, Cleanup Grants

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<sup>42</sup> For example, the Department of Housing and Urban Development (“HUD”) Brownfield Programs include the Economic Development Initiative (“EDI”) and Brownfields Economic Development Initiative (“BEDI”) programs. EDI subsidizes loan guarantee funds and reduces the risks to local Community Development Block Grant (“CDBG”) funds that serve as the first line of security for paying the guaranteed loan. BEDI grants enhance the security or improve the viability of a project financed with Section 108 guaranteed loan authority. Section 108 is the loan guarantee provision of the CDBG program. Various programs exist under the Department of Commerce, and Department of Transportation, amongst others.

<sup>43</sup> 42 U.S.C. 9604(k)(2)(A)(ii).

<sup>44</sup> Eligible governmental entities include, states tribes, local governments, councils of governments, and chartered redevelopment agencies. *See* 42 U.S.C. 9604(k)(1).

The Brownfield Revitalization and Environmental Restoration Act authorizes \$200 million per year through fiscal year 2006<sup>45</sup> for grants to eligible entities. This money is to be used for (1) assessment grants; (2) Revolving Loan Fund Grants; and (3) Cleanup Grants.

Assessment grants must be used to inventory, characterize, assess and conduct planning and community involvement related to brownfield sites. These grants may be awarded up to \$200,000 per site, but EPA has discretion to increase this amount to \$350,000 under certain circumstances.

Revolving Loan Fund Grants provide funding for a grant recipient to capitalize a revolving loan fund and to provide subgrants to others to carry out cleanup activities at brownfields sites. Thus, funding under this grant is available to not only the statutory eligible entities, but also to private entities by providing subgrants. Funding up to \$1 million is available per applicant.

Cleanup Grants are direct grants for the cleanup of brownfields sites. These grants are available for up to \$200,000 per site. Cleanup grants require a 20 percent match (although this may be waived upon a showing of hardship).

These grants are competitive and are awarded after a comprehensive review of the proposals by the EPA.<sup>46</sup> Proposals are judged on factors that include the extent to which the money will be used to protect human health and the environment; spur redevelopment and create jobs; preserve open space and parks; represent a fair distribution between urban and rural areas; and involve the local community.

Additionally, the Brownfields Act permits sites with petroleum contamination to be addressed,

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<sup>45</sup> 42 U.S.C. 9604(k)(12).

<sup>46</sup> Proposals are usually due at the end of the calendar year for all three grants. The due date for grants to be awarded in 2004 was December 4, 2003. The due date for 2005 grants has not been determined yet. Prospective applicants should consult the EPA website to determine when proposals for 2005 grants are due.

and stipulates that 25% of what Congress appropriates for the program (up to \$50 million) may be used for sites with petroleum contamination. Furthermore, grant recipients may use a portion of the site assessment or cleanup grants to pay insurance premiums that provide coverage (such as for cleanup cost overruns) for these sites.

### (c) Job Training Grants

CERCLA authorizes EPA to provide grants for training, research, and technical assistance to individuals and organizations, in order to facilitate assessment, remediation, or preparation of brownfield sites. Up to \$200,000 per job training grant is available through this program.

## 2. State Assessment Funds

### (a) Brownfields Site Assessments

EPA also provides assessment grants to states, to be administered by the environmental agency of that state. Approximately \$350,000 in federal funds was made available to the TCEQ in fiscal year 2003, for conducting Brownfields Site Assessments (BSA).

BSAs are essentially Phase I and Phase II Environmental Site Assessments. In addition to performing the site assessments, the TCEQ will provide regulatory guidance. This guidance includes developing cleanup levels, cleanup options, and clarification of environmental regulatory requirements as applicable.

These grants usually do not exceed \$30,000 and generally include record reviews, site reconnaissance, interviews, and sampling performed under TCEQ contract.

## 3. Tax Incentives

Just as grants, loans, and technical assistance can help cover the costs associated with identifying and reducing environmental risk, there are a number of tax incentives available under State and Federal law that can help reduce the bottom line impact of those costs.

(a) Federal Tax Incentives

Originally signed into law in August 1997,<sup>47</sup> and later amended on December 21, 2000,<sup>48</sup> the Taxpayer Relief Act, which included the Brownfields Tax Incentives<sup>49</sup> allows eligible taxpayers to deduct certain environmental cleanup costs at eligible properties, within the year they were incurred, rather than having those costs capitalized over time. The tax incentives apply to properties that meet both land use and contamination qualifications. To satisfy the land use requirement, the property must be held by the taxpayer incurring the eligible expenses for use in a trade or business or for the production of income; or the property must be included in the taxpayer's inventory. To satisfy the contamination requirement, the taxpayer must demonstrate that there has been a release, threat of release, or disposal of a hazardous substance at the property.

(b) State Property Tax Incentives for Brownfields Sites

The Texas Tax Code allows municipal or county taxing authorities to provide property tax relief for the development or redevelopment of certain brownfield properties that are located within a reinvestment zone and have been cleaned up through the VCP.

To be eligible, the real property must be located in a reinvestment zone created under the Texas Tax Code; not be in an improvement project financed by tax increment bonds; have received

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<sup>47</sup> Pub.L. No. 105-34.

<sup>48</sup> Pub.L. No. 106-54.

<sup>49</sup> The 1997 Act only covered expenditures at properties that met specific land use, geographic, and contamination requirements. To expand the use of the tax incentive, the geographic requirements were eliminated when the Act was amended on December 21, 2000, leaving only land use and contamination qualifications for expenditures on or after December 21, 2000. However, expenditures prior to that date (and on or after the incentive's effective date of August 5, 1997) must have been paid or incurred at properties that also meet the geographic conditions.

a Voluntary Cleanup Certificate of Completion from the TCEQ; and have had the value adversely affected by the release of a hazardous substance or contaminants according to the two preceding appraisals by the appraisal office.

To get tax relief, the owner of the brownfield property must enter into a tax abatement agreement with the taxing authority. The taxing authority can exempt from taxation the following:

- not more than 100 percent of the value of the property in the first year covered by the agreement;
- not more than 75 percent of the value of the property in the second year covered by the agreement;
- not more than 50 percent of the value of the property in the third year covered by the agreement; and

not more than 25 percent of the value of the property in the fourth year covered by the agreement.<sup>50</sup>

## V. CONCLUSION

In the coming months and years, industry and developers alike are likely to approach qualifying cities across the State to encourage the passage of MSD- ordinances and resolutions in hope of expediting cleanups and redevelopment projects. Moreover, cities with their own cleanup projects are likely to realize the significant cost savings as a result of their ability to control a major component of the MSD process.

Furthermore, cities will be able to use the MSD process, in addition to the many other “brownfield tools” discussed above to help encourage the redevelopment of historically contaminated properties and return them to productive use and the tax rolls. No doubt, familiarity with all of the brownfield reforms, legal defenses, and grant programs discussed above could prove extremely valuable to every city attorney in Texas.

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<sup>50</sup> See Texas Tax Code, Title 3.

