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# The Farm and Ranch Guide to Environmental Auditing[1]

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## Introduction

Because of excessive costs of cleaning up contaminated properties, the environmental audit is becoming a standard feature of most real estate transactions. The environmental audit has increased in popularity due to the potential liability under current environmental legislation. Under existing law, "owners or operators" of the facility contaminated with hazardous wastes are held responsible for the cost of cleanup. In many instances, the costs of cleanup far exceed the value of the property. The environmental audit provides individuals engaged in property transactions some degree of liability protection. The audit has supported the adage that "forewarned is forearmed" as environmental liability has become a business reality.

## Why Are Environmental Audits So Important?

The use of environmental audits has become increasingly important largely as the result of the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), also known as the Superfund. In addition, many states have enacted statutes encouraging the use of environmental audits (1-6 ENVLPG, Section 6.05A, 2001). States with laws that grant immunity from penalties or prosecution for voluntary discovery include Alaska, Arkansas, California, Colorado, Idaho, Illinois, Indiana, Kansas, Kentucky, Michigan, Minnesota, Mississippi, Montana, Nevada, New Hampshire, New Jersey, Ohio, Oregon, Rhode Island, South Carolina, South Dakota, Texas, Utah, Virginia, and Wyoming.

CERCLA provides a fund for the cleanup of contaminated sites when no other parties are able to carry out the cleanup. CERCLA enables the United

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States Environmental Protection Agency (EPA) to recover cleanup costs from those parties responsible for the contamination.

As amended by the Superfund Amendments and Reauthorization Act (SARA), CERCLA also provides stiff penalties for owners and operators of contaminated facilities who fail to report releases of hazardous substances or the presence of known contamination. As written and interpreted by the courts, the law is applied retroactively, strictly, and joint and severally. When the law is applied retroactively, an individual can be held responsible for contamination activities that occurred years before the enactment of CERCLA. *Strict liability*, or liability without fault, is significant in that the parties cited by the EPA may be held responsible for cleanup costs even though they played no role in the contamination. *Joint and several liability* enables the EPA to pursue any single individual as though he were fully responsible for the entire contamination.

CERCLA recognizes several distinct classes of parties responsible for the cost of site cleanup. These potentially responsible parties (PRPs) include the following:

1. *generators* of the waste;
2. *transporters* of the waste, including those who arranged for the transportation;
3. current or past *owners or operators* of the facility.

A facility is defined as any area where a hazardous substance is located. This would include contaminated farm or ranch land.

Some defenses are available for individuals cited as PRPs. These defenses rely heavily on the PRP's investigation of the site before and during the course of the business transaction. As such, the environmental audit plays a key role in raising the defenses available through CERCLA. While an audit does not guarantee a risk-free transaction, it can dramatically limit liability exposure by uncovering potential hazards.

## What Is the Definition of an Environmental Audit?

The EPA, in its auditing policy "Incentives for Self-Policing: Discovery, Disclosure, Correction, and Prevention of Violations" (65 FR 00-8954, 2000) provided what has now become a widely quoted definition of environmental audits.

> "Environmental auditing is a systematic, documented, periodic, and objective review by regulated entities of facility operations and practices related to meeting environmental requirements."

The foundation of all audits rests on research of the history of use (and abuse) of the facility in question. This research may involve a search and review of all documents relating to the history and use of the facility and a physical inspection and/or sampling of the property. Properly conducted, an audit should turn up indicators of possible contamination as asbestos building materials, PCB contamination, abandoned dumps, contaminated waste-water discharges, or underground storage tanks (Evans, 1989).

There are three classes of environmental audits: transactional, compliance, and management. Transactional audits occur when the ownership of property changes hands. Therefore, both the buyer and seller have an interest in determining the present condition of the property. Compliance audits are used to evaluate issues of regulatory compliance that arise in the day-to-day operations of a business. Management audits assess compliance with environmental laws.

### *Transactional Audit*

A transactional audit, also known as a Phase I Environmental Site Assessment (ESA), is a process that involves an investigation of real estate in an attempt to determine whether the property is contaminated. Many prospective purchasers of real estate will have an ESA performed in order to secure financing and to avoid ownership of contaminated real estate, which may require excessive cleanup costs. Lending institutions generally require an ESA before utilizing real property as collateral to secure a

loan because foreclosure proceedings can result in the lender becoming the owner of contaminated property.

### Advantages to the Buyer

Advantages to the buyer of real estate in conducting a pre-purchase transactional audit include the following:

- Satisfies the due diligence requirement for establishing the "*innocent landowner*" *defense* available under the amended Act. Section 9601(35) and Section 9707(b)(3)(a) and (b) of SARA provide for a narrow exception from liability for cleanup costs for an innocent purchaser, who acquires the property "after the disposal or placement of the hazardous substance on, in, or at the facility." To raise the defense, the innocent purchaser must prove that he "did not know and had no reason to know that any hazardous substance . . . was disposed of on, in, or at the facility." For the innocent landowner to establish that he "had no reason to know" of the presence of the contamination the Act requires that the purchaser undertake, at the time of the acquisition, all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice in an effort to minimize liability. This "appropriate inquiry", known as the "due diligence" requirement, usually takes the form of an environmental audit.
- Ensures that all *required permits* are available and current, so as not to bar the buyer's anticipated commercial use of the property.
- Reveals the need for *special insurance* or other costly purchases that may impact the sale process of the property.

### Advantages to the Seller

Advantages to the seller of real estate in conducting a pre-purchase transaction audit include the following:

- Establishes the *condition of the property* at the time of sale.
- Informs the seller of any *potential environmental liability*.
- Provides the seller with a factual basis for any *warranties* and/or pre-sale assertions that he might make, which could translate into a higher purchase price.

### Phase 1 ESA

In May 1993, the American Society of Testing Materials (ASTM) published a list of standard practices for conducting an Environmental Site Assessment, or ESA (1-6 ENVLPG Section 6.05, 2001). The four components of a Phase I ESA, according to the ASTM, are as follows:

1. A records review, including a review of the chain-of-title documents, to identify recognized environmental conditions that have impacted the property. This review should extend to those properties located within a short distance of the property in question.
2. A site visit, performed by an "environmental professional", consisting of a physical walk-through to visually observe the property to estimate the likelihood of environmental problems.
3. Interviews of owners and occupants of the property conducted by the environmental professional to identify environmental conditions associated with the property.
4. Preparation of a report outlining, "recognized environmental conditions", if any, discovered during the ESA process.

If the Phase I ESA uncovers potential problems, a Phase II ESA can be conducted to further investigate the degree and severity of contamination. This investigation can include the collection and analysis of soil, water, or air samples to confirm whether contamination is present and, if so, the extent of the contamination.

### *Compliance Audit*

A compliance audit involves a more comprehensive investigation than a transactional

audit because it is conducted in an active facility to assess that facility's level of compliance with federal, state, and local laws, regulations, and ordinances governing the generation, treatment, storage, and disposal of water. This assessment can be useful by:

- Surfacing deficiencies in operational practices that could expose the owner or operator of the facility to CERCLA liability.
- Revealing methods of streamlining present practices that could cut costs and provide a basis on which to project future costs of regulatory compliance.
- Encouraging self-regulation by private industry, resulting in better compliance with environmental standards.
- Qualifying for EPA guidelines to reduce or waive penalties through voluntary discovery, prompt disclosure and prompt correction of violations (65 Federal Regulations 19630-01, 2000).

### *Management Audit*

A management audit assesses a facility's likelihood of being in compliance with environmental laws by focusing on issues such as the environmental compliance chain of command and the amount of employee training. The goal of a management audit is to identify areas within the company and the facility that are in need of correction or improvement. Conducting management audits and taking corrective action can help increase a facility's compliance with environmental laws (1-6 ENVLPG Section 6.02, 2001).

Under the ASTM standards, an "environmental professional" is required to conduct the ESA. Compliance audits may be performed by either an internal or external consultant. Naturally, care should be taken in hiring competent professionals.

An attorney's presence on the environmental audit team may also be necessary to:

- provide the audit team with detailed knowledge of the laws, regulations, and permits that apply to the facility.
- protect the confidentiality of the survey by establishing the attorney-client privilege.
- fashion the necessary risk allocation provisions (i.e., balancing risk responsibility on all parties involved) in the transaction.
- legally evaluate any information obtained during the survey with regard to reporting (disclosure) requirements.

## What Should Be the Assurances of a Completed Audit?

The full impact of a proper or erroneous audit is unknown. Absolute certainty as to the health of the facility in any environmental audit is virtually impossible to guarantee. Professional consultants are not insurers against environmental liability. Nevertheless, a statement from the consultant that demonstrates reasonable efforts under the constraints of time and funding can be expected. Additional assurances can be provided by the consultant by way of "errors and omissions" insurance. If available, the insurance is expensive and will result in higher audit costs. The deductible of the policy should be checked as well as any exclusions. Finally, it is important to obtain a final audit report rather than simply relying on checklists generated from the audit. Such a report will provide a factual basis for conclusions drawn from the raw data and may also assist in demonstrating due diligence.

## Environmental Audits as Applied to Farm and Ranch Concerns

Storage, use, and disposal of crop management materials and other hazardous substances are practices common to farm and ranch operations. As such, the prospect of site contamination remains high, especially with older operations (Missimer, 1990). Incorporated within CERCLA's defense provisions is a provision that provides some liability protection for agricultural producers. CERCLA exempts the producer "for any response costs or damages resulting from the application of a pesticide product registered under the Federal Insecticide, Fungicide, and Rodenticide Act" [42 U.S.C. Section 9607(i)]. Specifically, the farm or ranch will not be considered a "Superfund" site, nor will the owner be

held responsible for the cost of cleanup, since pesticides applied in compliance with labeling are not considered hazardous substances (Wadley and Settle, 1989). This also includes the normal application of fertilizers. However, soil and ground and surface water contaminated by the improper use, storage, or disposal of registered pesticides can result in CERCLA liability.

Some of the more serious on-farm contamination problems involve active and/or abandoned agrichemical mixing and loading sites and cattle dipping sites. Here, cleanup costs can be excessive. As a result, lending institutions are increasingly wary of becoming financially involved with farming operations, and many are now requiring detailed questionnaires and audits as a condition of farm purchase and production loans (Duncan, 1992). Farmers and ranchers are also becoming extremely cautious about their lands becoming contaminated while leased.

In time, because of the concern of environmental liability, the environmental audit will become as commonplace in real estate transactions as the termite inspection. CERCLA and other environmental laws and regulations are spurring a variety of industries, including agriculture, to address even further the issue of toxic contamination and develop environmentally-friendly procedures as a prerequisite for doing business. The environmental legislation of the 1970s and early 1980s has become the business reality of the twenty-first century.

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