Environmental law considerations for your Canadian business: Assessing and minimizing risk in real estate transactions

Environmental Alert

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This is the first in a forthcoming series of articles highlighting the many ways that environmental law issues can impact your business. In this article, we will address some of the key environmental considerations that all business owners should take into account when entering into agreements of purchase and sale and leases.

As a result of provincial legislation and the common law (and in Quebec, the civil counterpart to the common law regime), owning or occupying contaminated land can lead to costly environmental liability for you personally and your business, even if your business did not cause the contamination. This article is not intended to provide a review of the different provincial regimes governing regulatory environmental liability or the various common law causes of action that can give rise to environmental liability. We recommend consulting with legal counsel to identify the applicable regulatory regime(s) that govern your business operations and to ascertain whether your business may be exposed to claims arising at common law.

In addition, environmental liability can arise from having “care and control” of contaminated property or contamination found at a property. This is a particularly important consideration for tenants occupying property pursuant to a lease because ownership of land is not necessary to give rise to environmental liability. Moreover, environmental consultants

often overlook or discount the potential environmental liability of businesses arising from the “care and control” principle or occupation of a property pursuant to a lease. This is why it is important to ensure that any proposed real estate transaction (purchase or lease) is reviewed by legal counsel to assess and propose strategies to mitigate potential risks.

Assessing risk: The due diligence process

In the real estate context, due diligence means taking all reasonable steps to confirm financial, legal, structural, zoning, and environmental concerns before you finalize an agreement. The due diligence process is the best way to identify and assess the environmental risk associated with a particular property before you seal the deal. It is important to note that any type of property may be contaminated and that one of the key considerations in the due diligence process is the history of a particular property and the surrounding properties. For example, many areas that are now being developed for residential purposes were historically used for commercial and industrial activities. The history of a particular property and the associated environmental risks may not be readily apparent based on its current use, which is why it is necessary to engage qualified environmental consultants and legal counsel with the appropriate experience to conduct a due diligence review.

Information regarding the history of an area and the associated environmental risks can be gathered from third-party sources such as the provincial environmental regulator and municipal government and/or from the other party to the transaction. In order to complete the environmental due diligence process you should consider engaging the services of an environmental consultant to carry out an environmental assessment for the property. Environmental assessments are broadly grouped under three levels of analysis, referred to as phases. Phase I (desktop review) and Phase II (subsurface testing) assessments could apply in the case of due diligence. Phase III involves remedial work.

There are certain matters which may arise during the due diligence process that are considered to be environmental “red flags” and warrant special attention, including:

- whether the property has ever been used as a waste disposal site;
- records of previous spills or discharges of contaminants at the property;
- records indicating the presence of above ground or underground storage tanks;
- the use and storage of hazardous materials at the property; and
- whether any of these conditions are present at neighbouring properties.

An environmental assessment can also be helpful to establish the baseline environmental condition of a property at the time of a transaction. This may become important information in the event that you need to distinguish between contamination that existed prior to the transaction and contamination occurring subsequent to the transaction.

A vendor may provide its own environmental reports to a prospective property purchaser as part of the due diligence process. A purchaser should treat any environmental reports prepared for a third party with caution. First, it may be difficult for a third party purchaser to assess the skill and reputation of the environmental consultant that prepared the report as well as the quality of the report itself. Second, the vendor may have provided the environmental consultant with specific parameters or constraints when carrying out their assessment, which limitations may not be readily apparent to a potential purchaser upon reading the report. Third, a purchaser relies on an environmental report prepared for another party at its own risk. The concept of extending “reliance” on environmental reports is beyond the scope of this article and will be addressed in a separate entry in this series. Lastly, the reports may be out of date. In light of the foregoing, purchasers should consider retaining their own consultant to conduct a “peer review” of any existing environmental assessment report. The purchaser’s environmental consultant should comment on the report’s scope, reliability and conclusions.

Minimizing risk: Agreements of purchase and sale

Once the due diligence is complete, and you have decided to proceed with the proposed transaction, you will need to ensure that any environmental risks identified during the due diligence can be translated into meaningful provisions in an agreement of purchase and sale to appropriately allocate environmental risks between the vendor and the purchaser.

Representations and warranties

An agreement of purchase and sale for property will contain certain terms, referred to as representations and warranties,

that the vendor will make with respect to the property for the purchaser's benefit. A representation is an assertion as to the truth of a fact, while a warranty is a promise of the character or quality of the property. Vendors will want to qualify or limit the scope of the representations and warranties to limit potential risk, whereas purchasers will seek broad representations and warranties with few qualifications. Some of the common qualifications placed on environmental representations and warranties include:

- *Knowledge*: Knowledge-qualified representations and warranties are less onerous for the vendor as they can limit the scope of environmental investigations to be carried out by the vendor prior to making the representation. Knowledge qualifiers are less desirable from the perspective of the purchaser. A potential purchaser should work with legal counsel to ensure that the necessary drafting modifications can be made to require a vendor to conduct inquiries to ensure that the environmental representations and warranties are accurate.
- *Time*: A vendor should seek to limit representations and warranties to matters arising during the term of the vendor's interest in the property, or even a shorter time period. From the perspective of the purchaser, however, the broader the time frame, the more comprehensive the representations and warranties.
- *Materiality*: Vendors can limit the scope of the representations and warranties by "materiality" such that a vendor need not disclose minor environmental issues. For example, if one of the environmental representations and warranties provides that there is no "material" contamination on the property this would significantly lessen the onus on the vendor to provide details regarding instances of minor contamination on the property.

Parties to a real estate transaction should review the draft agreement with legal counsel before signing to ensure that any potential environmental red flags are covered off appropriately and to avoid inadvertently assuming environmental risks. Representations and warranties are often heavily negotiated and even small changes in the language of an agreement or purchase and sale can have a major impact on the interpretation of a specific clause.

Indemnities

Indemnities are powerful tools to allocate potential environmental risk as between a vendor and purchaser. An indemnity is a contractual promise by the party offering the indemnity to reimburse the party receiving the indemnity in respect of a specified loss. In an agreement of purchase and sale, a purchaser will typically seek an indemnity from the vendor in respect of any losses arising from breaches of the vendor's representations and warranties.

In the environmental context, parties to a real estate agreement may also seek an indemnity in respect of environmental claims. For example, if there is a known environmental issue for which the vendor could be liable prior to selling the property, the purchaser might negotiate an indemnity to be given by the vendor in respect of that liability. If the environmental liability does in fact come to light after the purchase of the property is completed, the vendor would have to reimburse the purchaser in respect of that liability. This could include costs arising from clean-up orders issued by a provincial environmental regulator or liability arising from third-party common law claims.

In most agreements of purchase and sale, a purchaser will seek to be indemnified in respect of pre-existing contamination at the property or contamination arising from activities carried out at the property prior to the close of the sale. A vendor may in turn seek to be indemnified in respect of any contamination arising at the property after it is sold.

An important consideration for parties when negotiating indemnities is the creditworthiness of the party offering the indemnity. If the party that provides the indemnity becomes insolvent, there will be no assets to satisfy a claim by the party that has received the indemnity, rendering the potential protection offered by an indemnity worthless.

Minimizing risk: Leases

Many of the environmental issues that warrant consideration in agreements of purchase and sale for property also come into play in leasehold relationships. However, there are a number of issues which can arise in the landlord and tenant relationship that will not be found in an agreement of purchase and sale.

One of the main concerns for a prospective tenant is protection against potential liability for pre-existing contamination at a property. This is particularly true where a tenant has limited knowledge regarding the historic use of the site. In such circumstances, the tenant will want to require an express covenant by the landlord as to the physical quality and fitness of the premises, as well as for the repair and remediation of any adverse environmental condition which arises as a result of pre-existing conditions or future conditions caused by third parties. Allocation of environmental risk can be achieved in the form of an indemnity from the landlord and should include coverage for any losses arising from interruption to the tenant's

business caused by the environmental condition of the property.

In turn, a landlord needs to obtain protection against potential environmental impacts caused by the activities of its tenant(s). Depending on the environmental risks associated with the tenant's activities at the site, standard clauses requiring a tenant to leave the premises clean and in good repair may not be sufficient to protect a landlord against liability for potential contamination. For example, where a site is leased for the purposes of operating a retail fuel outlet, a landlord may include in the lease a covenant requiring the tenant to conduct regular soil and groundwater testing and to carry out soil and groundwater remediation at the expiration of the lease term.

Where there are significant environmental risks associated with a specific site or proposed tenant's activities, it is advisable to obtain an environmental assessment at both the commencement and termination of a lease. This will allow the parties to determine if there is any contamination present at the outset of the lease as well as any contamination arising during the term of the lease.

In the next article in this series, we will talk about how to work with environmental consultants when looking to purchase or lease real property.

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