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Buying Contaminated?Effectively managing environmental issues that affect property purchases

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Michael D. Frede
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 Buying Contaminated?
 Effectively managing environmental issues that affect property purchases

By Michael D. Frede

Many people involved with real estate in the self-storage industry are familiar with how environmental liabilities can significantly affect the profitability and viability of a self-storage development. However, recent changes in environmental regulations have created new opportunities for purchasing sites previously considered to be environmentally "risky." Developers can now more seriously consider buying a contaminated site because environmental issues, when effectively managed, are less likely to hinder the overall business plan.

History of Regulatory Trends

Originally, the liability for environmental contamination was to be borne by the entity that caused the contamination. However, the reauthorization of the Superfund Act in 1986 (SARA) shifted the liability to the current property owner, whether he caused the contamination or not (it cost the government too much to chase down the responsible party).

This simple change caused a tidal wave of changes in the public and private sectors. The lending industry was now more at risk because it was forced to choose between foreclosing on contaminated property (and taking on the responsibility of the site conditions) or writing off a loan. The environmental-consulting industry, almost nonexistent prior to that point, absorbed a huge increase in work it wasn't overly experienced at, and implemented programs for the research and development of new technologies. The legal industry was forced to establish new precedents in lawsuits brought to allocate the responsibility for the costs of contamination between current and past landowners. Lawmakers were forced, without adequate technological data, to implement new policies that would protect our natural resources without significantly affecting the lending industry or private-property owners.

Also, the rapidly changing regulations threw a scare into the entire real-estate industry because the future risks could not be defined. As time has passed, pressure from lenders and private-property owners, as well as experience gained by the consulting industry, have demonstrated that the original regulations were too strict. Their strict policies caused many contaminated sites that didn't really pose a risk to human health or the environment to be remediated.

Typical Environmental Conditions

The inexperienced developer typically thinks that environmental risks are rare (something that happens to the other guy) and are limited to large industrial properties, such as steel mills, chemical plants--and "those large facilities with smoke stacks." However, the most common properties with contamination--and those most likely to affect self-storage developers--are existing or former gasoline stations, dry cleaners, auto-repair businesses, paint shops, etc. Although these types of properties usually are not a Love Canal kind of situation, they can have contamination that previously would cost hundreds of thousands of dollars to investigate and remediate--enough to bankrupt a smaller developer or at least significantly affect the financial viability of a self-storage project.

Another common type of environmental condition is land that has been filled. Frequently, the fill contains materials that can cause contamination (e.g., chemical barrels, foundry sand, asphalt debris and wood chips from utility facilities). In addition, many properties are contaminated because they lie near other contaminated sites. Contaminants will migrate downward with rainwater infiltration until they reach the groundwater table, then migrate horizontally as the groundwater flows through the soils or bedrock. In either case, the presence of contamination is an issue that needs to be evaluated, whether it was caused by the owner or originated on site or not.

New Purchaser Advantages

In recent years, regulators have developed a more relaxed attitude that has resulted in reduced economic risk for many contaminated properties so they may become financially viable development options. Regulators have been convinced that not all contamination needs to be remediated. Liability-limitation statutes have eased concerns that future regulatory changes may result in undefined risks that make lenders, lawyers and developers nervous.

Many states have written new rules that also limit the maximum cost of remediation when specified investigation guidelines are followed. Regulators are also willing to offer third-party indemnification letters when contamination is found on a site that is proven to originate off site. Court cases have established precedents that define responsibility for contamination; this helps lenders and owners identify their risks. Also, lender liability has been reduced when they demonstrate that they were not involved in the operations of the business.

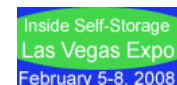
Many states have developed alternatives to costly remediation efforts, such as institutional controls (e.g., well and construction restrictions and deed notices) and engineering controls (e.g., covering an area with pavement) so that health concerns are still addressed. Many public agencies have established special "brownfield" grant and loan programs to not only assist, but encourage, the development of contaminated property, although these programs have limited access for the private, for-profit development sector. In fact, the local government entity routinely assists

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in numerous ways when someone is willing to develop a contaminated parcel.

In addition, the insurance industry has created policies that can be purchased by property owners to replace financial uncertainty with specified costs. Although premiums for such policies can be pricey, these policies place a ceiling on potential cleanup costs. With all these advantages, purchasing and developing a property with environmental issues is not as costly and risky as it used to be.

Recommendations Before Purchasing Property

Prior to purchasing any property, you should become familiar with its history and geological conditions. It is prudent to identify any unusual environmental and construction costs for budgetary reasons. It is also prudent to protect the large investment needed to develop a site from unexpected costs. Prior to providing a loan, lending institutions will complete an environmental-screening questionnaire to determine the necessity for a Phase I environmental site assessment. A Phase I consists of historical research and a site reconnaissance, and its purpose is to evaluate the potential for contamination to exist from past site or nearby activities. Completion of an ASTM Standard Phase I is necessary to qualify for the "innocent landowner defense."

If the Phase I concludes that there is a potential for contamination to exist, a Phase II should be conducted. A Phase II consists of collecting soil and/or groundwater samples at specific areas for specific chemicals to confirm the presence or absence of contamination. A Phase II does not define the size of the contaminated area or determine if remediation is warranted.

If the Phase II confirms the presence of contamination, a complete remedial investigation/feasibility study (RI/FS) is necessary to determine the need and costs for remediation. Usually, the buyer and seller will enter into negotiations to determine who will be responsible for completing the RI/FS, and how the selling price may be affected. An RI/FS consists of a thorough scope of soil and/or groundwater sampling to define the extent and degree of contamination, determine the necessity for remediation, and identify the most appropriate method of remediation, if needed. Prior to this phase, the regulatory agency has not been involved in the process. This is the point that the new regulatory attitude, which affects the need and scope of cleanup actions, can significantly reduce project costs.

Unlike other industries, the self-storage industry can take advantage of some of the emerging alternatives to costly remediation methods. One alternative consists of paving an area of contamination to inhibit the infiltration of rainwater or melting snow. Since storage-facility sites are covered with pavement and buildings, this option is a natural fit. Also, environmental problems don't create the stigma that would exist with many other types of businesses, such as restaurants, day-care centers and office buildings.

Market forces (i.e., perceived liability risks) that can affect the costs of a project still exist, but those forces are increasingly less significant as the private real-estate market continually gains experience in dealing with environmental issues, and prime locations become more scarce. Also, what an owner can gain in reduced costs needs to be weighed against the increased time it may take to obtain a "closure letter" from the regulatory agency because additional requirements for investigating and monitoring a site may be requested before the regulator is comfortable with the conditions.

Conclusions

Recent changes to environmental laws have created more financially viable properties because of the lower cleanup standards. More entrepreneurial and private companies can readily take advantage of these changes. Buyers do not have to walk away from an otherwise attractive property because, not only are potential remediation costs lower, but limited grant and loan programs and liability-limitation laws can reduce out-of-pocket costs.

A savvy, knowledgeable buyer can use the historical attitudes that promote lower property values on contaminated sites to obtain otherwise viable sites that others have avoided at below-market prices. This can increase the potential net-operating income and equity of the development. Environmental risks still exist, but are more manageable than in the past and actually can be less significant in the financial viability equation than many other factors.

Michael D. Frede is a registered professional engineer, and the president and owner of King Development LLC and Drake Environmental Inc. Mr. Frede has more than 15 years of consulting experience in the fields of geotechnical and environmental engineering. He has conducted geotechnical and environmental investigations in 32 states.

Mr. Frede wishes to extend his appreciation to two professionals who contributed their valuable time and knowledge to assist him in producing this article: Mr. John M. Van Lieshout, environmental attorney with the Milwaukee, Wis., office of Reinhart, Boerner, Van Deuren, Norris & Rieselbach, S.C.; and Mr. R.K. Kliebenstein, vice president of integration, Extra Space Storage, Las Vegas, Nev.

Definitions

ASTM--American Society for Testing and Materials: an organization that develops consensus standards and related technical information for industry.

Closure letter--A letter from the governing regulatory agency indicating that additional investigation or remediation of a contaminated property is no longer necessary. Closure letters are either unconditional or conditional, and their requirements vary from state to state. An unconditional closure effectively places no restrictions on the property--the property may be treated the same as a property that was never contaminated. A conditional closure places one or more restrictions on the property that are typically enforced by a deed restriction or notification. Such restrictions may limit certain uses of the property (such as for potable water) or may require certain actions (such as maintaining a cap or barrier to isolate contamination).

Innocent landowner defense--That defense to the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) provided in 42 USC §9601(35) and §9607(b)(3). One of the requirements to qualify for this defense is that the party make "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice." (ASTM, Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process, E 1527-97, p. 5.)

Remediation--The implementation phase of a site cleanup that follows a remedial investigation/feasibility study (RI/FS); may consist of active or passive methods to eliminate soil and/or groundwater contamination.

RI/FS--Consists of a remedial investigation, an in-depth study designed to gather the data necessary to define the extent and degree of contamination, followed by a feasibility study, consisting of the analysis of potential cleanup alternatives for a site and, possibly, an evaluation to determine whether a proposed remedial method will be effective considering the environmental conditions of the subject site.

SARA--Superfund Amendments and Reauthorization Act (1986); federal law reauthorizing and expanding the jurisdiction of CERCLA.

Site reconnaissance--A site visit during which visual and physical observations are made to the subject property and any structure(s) located on the property to the extent not obstructed by bodies of water, adjacent buildings or other obstacles (ASTM, p. 13).

Superfund--The program operated under the legislative authority of CERCLA and SARA that funds and carries out the Environmental Protection Agency's solid waste emergency and long-term removal and remedial activities.

Third-party indemnification (i.e., liability exemption)--In the case of environmental contamination, an owner's legal exemption from the liability associated with the presence of contamination on the owner's site when the contamination originates from off site.

Brownfields

What they are, how to use them to your advantage

By Michael D. Frede

King Development LLC was created by the owners of Drake Environmental Inc. to purchase and remediate contaminated properties to either sell or develop with self-storage facilities. King Development focuses on a specific type of contaminated property; brownfields. Brownfields are abandoned or underused industrial or commercial properties where site upgrading or redevelopment is hindered by known or perceived environmental contamination.



At all government levels, the interest in cleaning up and returning brownfields to productive use has moved this specific environmental issue to a major public-policy issue. The Environmental Protection Agency estimates there are 450,000 brownfields in the United States. In the State of Wisconsin alone there are an estimated 8,000 brownfields, 1,500 of which are believed to be tax delinquent. If left as is, these properties present health, economic, environmental and social challenges to the communities in which they are located.

Some brownfields exist because property owners have been unable or unwilling to incur the costs to investigate or cleanup their land when contamination is suspected or known to exist. Consequently, the property is abandoned, which forces the lender (if a mortgage exists) or government entity (if back taxes exist) to consider foreclosure. Many lenders and government bodies will not foreclose on environmentally questionable property due to liability, and the property may remain abandoned for years. When the environmental conditions go uncontrolled, a property becomes an eyesore and adversely affects the tax base.

The process that King Development follows varies from site to site. Due to the company's unique experience in investigating and remediating contaminated properties, it can select the most financially feasible brownfield sites to purchase. Then, in some cases, it will purchase the property directly from the current owner at a discounted price, depending on the estimated costs of investigation and cleanup, site preparation, and any back taxes or liens that exist. For some properties, King Development may work through a foreclosure action with the government body to obtain ownership. In these cases, the company will also be able to purchase the property at a discounted price, especially since all liens and back taxes are usually eliminated.

An important factor that makes brownfields projects financially viable is the regulatory changes that have recently occurred in the area of cleanup standards. These changes have greatly reduced the costs necessary to remediate contaminated land. In many situations, no remediation is warranted because the investigation results demonstrate that the conditions do not exceed the new cleanup standards and are not harmful to human health or the environment. Consequently, closure letters from the regulatory agencies, which state that no further investigation or cleanup is necessary, are more easily obtained.

In summary, King Development is able to identify properties that can be purchased and brought into environmental compliance at a cost less than the fair market value. Because King Development evaluates the environmental and economic conditions prior to purchasing a selected property, which provide an indication of the financial viability of the property as a self-storage facility, additional equity and higher net-operating income (NOI) can be achieved.

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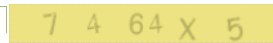
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