

OSBORN

Dealing With Environmental Risks In Construction Contracts

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John E. Osborn and Paul R. Schreyer

During the initial planning phase of a project, an owner or developer(1) should appreciate the potential for additional costs due to the existence of hazardous substances and other similar environmental concerns. This is true for both new construction and for renovation projects.

Suppose a developer attempting to locate a suitable site for a new building unknowingly purchased a parcel of land containing a hazardous substance. Under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), enacted in 1980 and commonly known as the Superfund Law, the developer could be liable for the total cost of cleaning up the site. If this cost is significant, it may destroy the feasibility of the project, or even worse, it may force the developer into bankruptcy.

A similar fate may be in store for the developer who proceeds with a renovation project and later discovers that the building contains a considerable amount of asbestos that must be removed or stabilized. For these reasons it is essential that developers identify, evaluate, and allocate to others, or assume for themselves, each environmental risk associated with a project.

Identifying Environmental Risks

Identifying environmental risks on a potential project requires intricate knowledge of both the site and the federal, state, and local statutes, regulations, and other rules that define the scope of liability. In each instance, the developer must become familiar with these laws, regulations, and rules and determine the extent of its responsibility or potential "exposure."

In addition to risks of encountering a hazardous substance or asbestos, a developer may be required by the Clean Water Act of 1977 (formerly known as the Federal Water Pollution Control Act) to obtain a permit for any work that could release "pollutants" into a body of water. The extent to which this Act may govern various construction projects has been increased by the broad definition accorded the term "pollutant." This term, as defined by the Act, includes, among other items, dredge spoil, solid waste, sewage, garbage, sludge, heat, wrecked or discarded equipment, rock, and sand.

Developers, architects, engineers, contractors, subcontractors, and suppliers must also be aware of the potential liability from the threat of "indoor pollution." The United States Environmental Protection Agency has determined that exposure to certain chemical compounds contained in building materials, office products, and cleaning agents may cause illness. In addition, tobacco smoke and microbes that breed in ventilation systems may pose serious health risks.

Ever since the energy shortage of the mid-1970s, building owners have been under economic pressure to reduce their heating and cooling costs. As a result, interior ventilation standards have been decreased and new ventilation systems have been designed to increase air recirculation. Although these procedures minimize energy costs, they increase the threat of injury due to indoor air pollution. The trend of recent litigation is that all parties involved in the construction or maintenance of buildings may be exposed to liability for these injuries.

In light of the potential liability created by environmental laws, developers are well advised to compile a checklist of environmental concerns to be addressed during the initial planning stage of each project. An evaluation should be made *prior* to purchase. Once the applicable risks have been identified, the relative significance of each risk must be evaluated.

Evaluating Environmental Risks

Assume that a developer intends to purchase a vacant downtown lot for the purpose of constructing a small commercial office building, and that the developer prepares a checklist of environmental concerns which includes, among other things, the possibility that the proposed construction site contains a hazardous substance. To evaluate this risk, the developer might consider doing the following prior to purchasing the site:

1. visiting the site;
2. questioning the prior owner concerning the past uses of the property;
3. speaking with adjacent landowners or occupants, local business owners, and others concerning the past uses of the property;
4. determining whether the property is listed on any hazardous waste site register;
5. determining whether any local regulations require underground tank registration, and if so, whether any tank has been registered in connection with the property;
6. engaging an environmental engineering firm to investigate the site to determine whether any hazardous substance is present, and if so, to what degree.

Retaining an environmental engineer to perform a thorough investigation is essential. Many environmental laws, such as the Superfund legislation, are essentially indifferent to the concept of fault. Accordingly, the current owner may be liable for cleaning up a site even though it had nothing to do with polluting that site. Although parties who owned the site at the time hazardous substances were deposited and parties actually responsible for polluting a site are liable for clean-up costs (joint and several liability), as a practical matter, they may be out of business or merely unable to contribute their fair share. Therefore, in our example, these laws create an incentive as well as a duty for the developer to thoroughly investigate a site prior to purchase. In light of the staggering risk, it may now be unwise *not* to employ an experienced environmental engineer at an early stage.

Special attention must be given to the scope of work to be performed by the environmental engineer. If the developer is knowledgeable in environmental hazards, it may only need the engineer to conduct an "informational" study to determine which, if any, hazardous substances are present on the site. If, however, the developer has no experience concerning environmental hazards, it may also require the engineer to suggest appropriate methods to dispose of or neutralize any hazardous substances found on the property. In

either case, the developer and the engineer must be careful to draft a contract that delineates the liability and risk assumed by each party.

For example, suppose a developer and an engineer make an agreement in which the engineer agrees to conduct an informational study. The engineer should make sure that the agreement clearly sets forth the types of hazardous substances it is being retained to investigate, the methods of investigation to be employed, and the anticipated reliability or accuracy of those methods.

If the engineer provides additional services to the owner, new questions of liability are raised. For example, if the engineer suggests a method to dispose of or neutralize a hazardous substance, what is the extent of the engineer's liability for the effectiveness of that method? Similarly, if the owner requests the engineer to recommend a hazardous waste contractor, to what extent is the engineer responsible for the contractor's performance? These questions must be addressed by clear and concise contract language.

Reconsider the list of inquiries that a developer might pursue prior to purchasing a building lot. A similar list should be compiled for each identified risk. For example, assume that in connection with the construction of the new office building the developer decided to perform demolition and renovation work within an existing structure located on the adjacent lot. The risk that the existing building may contain asbestos must be evaluated in much the same way as the possibility that the site for the new construction may contain a hazardous substance. The evaluation process is intended to provide the developer with the necessary information to make a well-reasoned decision concerning each risk. Only after a risk is correctly evaluated may it effectively be allocated or assumed.

Allocating Environmental Risks

Once a developer has evaluated the environmental risks associated with a project, the next step is to determine what action should be taken with regard to each identified risk. In some instances, the developer may decide to allocate a certain risk to another party by contract. In others, the developer may decide to assume the risk itself.

For example, suppose that in the previous hypothetical situation the developer, prior to contracting for any demolition or renovation work in connection with the existing structure, had hired an environmental engineering firm which discovered that some of the building's boiler pipes were insulated with an asbestos-containing material (ACM). Based on this information, the developer may decide, by payment of a substantial contract sum, to allocate the risk associated with the removal or stabilization of ACM to an asbestos abatement contractor.

The contract between the developer and the asbestos abatement contractor, similar to the contract between the developer and the environmental engineer, must clearly set forth the liability assumed by each party. It would be impractical for a developer who has decided to shift the risk associated with removing or stabilizing ACM to an asbestos abatement contractor to enter into a contract under which the contractor assumed no liability for the effectiveness of its services. On the other hand, if the contractor is willing to assume this risk, the contract must spell out the methods the contractor will employ and the expected results.

The contractor who agrees to perform work outlined in an engineer's report should consider incorporating that report into its contract with the developer, thereby limiting the scope of its work, and presumably its liability. In other words, if the engineer has already assumed responsibility for discovering ACM in a building, then the contractor should only promise to remove the ACM previously identified and should not guarantee the developer it will remove all ACM existing within the structure.

The contracts by which a developer allocates an environmental risk must be well tailored for the specific project. The risks are so substantial in many instances that a court may be unsympathetic to a developer's argument that boilerplate exculpatory language is capable of shifting the risk to the other party. This is true whether the developer is allocating the risk associated with ACM to an asbestos abatement contractor as in the above example, or allocating the risk resulting from the presence of a hazardous substance to a hazardous waste contractor. In addition, when the developer allocates a risk under one contract, this undertaking must be reflected in each of the remaining contracts for that project (architect/engineer, contractors, subcontractors, etc.).

Consistent with this view, the American Institute of Architects (AIA) has recently amended its standard contracts. AIA Document A201, General Conditions of the Contract for Construction (1987 Edition) provides in Article 10.1.2 the following:

In the event the Contractor encounters on the site material reasonably believed to be asbestos or polychlorinated biphenyl (PCB) which has not been rendered harmless, the Contractor shall immediately stop Work in the area affected and report the condition to the Owner and Architect in writing. The Work in the affected area shall not thereafter be resumed except by written agreement of the Owner and the Contractor if in fact the material is asbestos or polychlorinated biphenyl (PCB) and has not been rendered harmless. The Work in the affected area shall be resumed in the absence of asbestos or polychlorinated biphenyl (PCB), or when it has been rendered harmless, by written agreement of the Owner and Contractor...

The language of this contract makes it clear that the contractor is not responsible for the risks associated with the presence of asbestos or PCBs. Similar language appears in AIAD document A401, Standard Form of Agreement Between Contractor and Subcontractor, and also in AIA Document B141, Standard Form of Agreement Between Owner and Architect (1987 Editions).

By eliminating liability of the general contractor, subcontractor, or architect for the presence of yet-undiscovered asbestos or other hazardous substances, the developer has enabled those parties to estimate the value of their services accurately, and hopefully, from the developer's standpoint, at a lesser price. The risk associated with the possibility that some hazardous substances may exist rests, according to these documents, squarely upon the developer, unless otherwise allocated.

This result is probably the most sensible for sites where environmental hazards have not yet been discovered. The developer, as the "moving force" behind the project (and "prime risk-taker"), is in the best position to later allocate environmental risks if any are encountered.

As a practical matter, general contractors, subcontractors, and architects are usually not equipped to abate hazardous substances (although the architect would be the party most likely to have responsibility for producing a design that would prevent indoor pollution). When unexpected environmental hazards are encountered, the most prudent course may be to seek a separate contractor who specializes in such removals. At least in theory, by allocating the risk to a highly specialized contractor, the risk should be abated for a reduced cost, and the developer's liability should be minimized.

Another method for a developer to shift risks connected with subsequent discovery or handling of hazardous substances is by paying for insurance coverage. Practical considerations may counsel against this approach, however, as the premium may be too expensive, the coverage may be too limited, or insurance may simply not be available at all.

Conclusion

Recent legislation, regulation, and case law have placed an onerous burden upon developers to provide for the preservation of the environment and to protect individuals from the adverse effects of hazardous substances. Each new project will be affected in some way by these laws. Developers must identify each environmental risk associated with the project, thoroughly evaluate each risk, and based on that evaluation, take the necessary steps to allocate each risk to a particular party, or to assume the risk itself.

Note:(1) The term "developer" is used in this article to describe a person or firm intending to purchase and improve real property or one who has already purchased property with the intention of improving it.