

The EPA's Proposed All Appropriate Inquiries Rule and the Appraisal of Contaminated Properties

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In previous editions of "Environment and the Appraiser," standards and methods for appraising contaminated properties were reviewed¹ and illustrated with case study examples.² In this edition of the column, we break from standards and methodology and discuss an issue that is important to the appraisal profession in general and in particular to those who focus some or most of their practice on the valuation of contaminated properties. This issue involves the proposed administrative rule of the U.S. Environmental Protection Agency (EPA) referred to as the "all appropriate inquiries" (AAI) rule and its relationship to existing guidance and practice in valuing contaminated properties.

In general, the AAI rule, as proposed, misses an opportunity to take advantage of the considerable progress that the appraisal profession has made in establishing acceptable methods and standards for valuing contaminated properties. This is reflected by the decision of the Negotiated Rulemaking Committee, of which EPA was one of the 24 members, not to require appraisals for purposes of estimating the fair market value of properties that may be the subject of AAI inquiries. As existing guidance in Advisory Opinion 9 discusses, in situations where property values are adversely impacted by contamination, there are actually two values that may be de-

termined—the hypothetical unimpaired value and the value in an "as is" or potentially impaired condition—in order to find the extent of any reduction in value as a result of contamination. The proposed AAI rule seemingly equates the property's fair market value with its unimpaired value, and its sale price with its actual "as is" impaired value, by requiring the purchaser to "make a general determination of whether the price paid for a property reflects its market value."³ Thus, the proposed rule omits the appraiser's role in estimating two values. These and other shortcomings will be discussed in detail herein.

Despite all this, the proposed rule could assist appraisers by providing information that would be of use in valuing a contaminated property consistent with Advisory Opinion 9 (AO-9), "The Appraisal of Real Property That May Be Impacted by Environmental Contamination," published with the Uniform Standards of Professional Appraisal Practice (USPAP).⁴ If the omission of the appraisal requirements were corrected, the rule could assist appraisers by providing useful information for the valuation of contaminated properties. This, in turn, would assist those involved with acquiring contaminated properties by providing them with reliable estimates of value upon which to base pricing and other decisions.

This column was prepared with the assistance of David Carciere, a graduate student in the Land Economics and Real Estate Program of the Mays Business School at Texas A&M University.

1. Appraisal Standards Board, Advisory Opinion 9, "The Appraisal of Real Property That May Be Impacted by Environmental Contamination" (Washington, DC: The Appraisal Foundation, 2005); and Thomas O. Jackson, "Methods and Techniques for Contaminated Property Valuation," *The Appraisal Journal* (October 2003): 311–320.
2. Thomas O. Jackson, "Case Studies Analysis: Environmental Stigma and Monitored Natural Attenuation," *The Appraisal Journal* (Spring 2004): 111–118; and Thomas O. Jackson, "Surveys, Market Interviews, and Environmental Stigma," *The Appraisal Journal* (Fall 2004): 300–310.
3. U.S. Environmental Protection Agency, "40 CFR Part 312: Standards and Practices for All Appropriate Inquiries," *Federal Register* 69, no. 165 (August 2004): 52567.
4. Appraisal Standards Board, *Uniform Standards of Professional Appraisal Practice and Advisory Opinions*, 2005 ed. (Washington, DC: The Appraisal Foundation, 2005).

Background of the Proposed AAI Rule

The proposed AAI rule was developed in response to the Small Business Liability Relief and Brownfields Revitalization Act of 2002 (“Brownfields Amendments”). The AAI rule and the Brownfields Amendments address certain protections from liabilities under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA, commonly known as Superfund). Under CERCLA, persons may be held liable for cleaning up a contaminated property that they either currently own or operated in the past. This strict liability can be assigned solely on the basis of property ownership. The CERCLA liability provisions offer liability protections for innocent landowners, as well as bona fide prospective purchasers and contiguous property owners, who have conducted “all appropriate inquiries into prior ownership and use of a property prior to or at the same time at which a person acquires a property.”⁵ The proposed AAI rule is intended to establish federal standards and practices for the conduct of all appropriate inquiries necessary for certain landowner protections created by the Brownfields Amendments.

The innocent landowner defense was established in the Superfund Amendments and Reauthorization Act (SARA) of 1986 for persons who could demonstrate that they did not know and had no reason to know of hazardous substances disposed of on or near the property prior to purchasing the property. In order to demonstrate that they did not know, the person is required to conduct all appropriate inquiries. Accordingly, prospective purchasers who do not conduct all appropriate inquiries may lose the ability to claim protection from CERCLA liabilities as an innocent landowner, bona fide prospective purchaser, or contiguous property owner. Important for appraisers, though, is that in the course of these inquiries, if contamination is discovered, the prospective purchaser must estimate whether the price paid or to be paid has been impacted by the presence of the contamination. The other AAI inquiries could then provide information for the appraiser to more accurately assess this issue.

Relevant Property Characteristics in the Appraisal of Contaminated Properties

Appraisers who value or analyze properties that may be impacted by environmental contamination must

have sufficient information from which to reliably assess the impacts of the contamination on property values. As set forth in AO-9, when appraising a property that may be impacted by environmental contamination, there are a number of relevant property characteristics that should be considered by the appraiser. The relevant property characteristics include, but are not limited to:

- 1) *whether the contamination discharge was accidental or permitted*, since there are many permitted releases of contaminants by industry for which there is no required cleanup, for which there is ample testing and monitoring, and that do not impact the cost and risk of investing in or owning real property;
- 2) *the status of the property with respect to regulatory compliance requirements*, since properties with contamination not in compliance could have greater risk and costs necessary to achieve compliance;
- 3) *the remediation lifecycle stage (before, during, or after cleanup) of the property as of the appraisal date*, since risk and cost can vary before, during, and after cleanup, as explained;
- 4) *the contamination constituents (petroleum hydrocarbons, chlorinated solvents, etc.)*;
- 5) *the contamination conveyance (air, groundwater, soil, etc.)*;
- 6) *whether the property is a source, non-source, adjacent or proximate site*, since these sites in these categories will have much different risks and costs due to contamination;
- 7) *the cost and timing of any site remediation plans*;
- 8) *liabilities and potential liabilities for site cleanup*, or who is responsible for site cleanup and its costs and whether these liabilities and the responsible parties were known as of the date of value;
- 9) *potential limitations on the use of the property due to the contamination and its remediation*; and
- 10) *potential or actual off-site impacts due to contaminant migration (for source sites)*. (AO-9, Lines 116-128)

AO-9 also states, “Since the appraiser is usually not an expert on the scientific aspects of contamination, experts from other fields will typically provide

5. Federal Register 69, no. 165 (August 2004): 52565.

this information." (AO-9, Lines 129-130) Accordingly, the inquiries made under the AAI rule by the "environmental professional," as defined therein, would be consistent with this statement in AO-9.

Inquiries in the Proposed AAI Rule

As noted, in order to gain the significant protections from CERCLA liabilities as an innocent landowner, a number of specific inquiries must be undertaken either by those seeking to establish such status or by a qualified environmental professional on their behalf to determine the extent to which the property may have been previously contaminated or contaminated by a party other than the party seeking protection from the CERCLA strict liabilities. Each of the AAI inquiries is discussed in this column and, where appropriate, is related to the requirements and guidance for valuing contaminated properties. As will be explained, many of these inquiries can provide information on property characteristics necessary in the appraisal process. However, in order to use this information, appraisers need some understanding of the specific inquiries and the information they may produce. This information may then be used, subject to appropriate *extraordinary assumptions*, as required by USPAP.⁶

Interviews with Past and Present Owners, Operators, and Occupants (Proposed 40 CFR § 312.23)

The proposed AAI rule requires inquiries of past and present owners, operators, and occupants of the subject property. This type of inquiry would require interviews by the environmental professional, or by an individual under close supervision of the environmental professional. The rule does not prescribe specific interview questions, leaving that up to the environmental professional. The EPA notes that the type and content of the questions will depend on site-specific conditions and circumstances.⁷ The purpose of the interviews is to collect information to enable the environmental professional to "render an opin-

ion with regard to conditions at the property that may be indicative of releases or threatened releases of hazardous substances."⁸

With respect to the relevant property characteristics as specified in AO-9 and cited here, this opinion would provide information of relevance to several of the elements, including items the contamination constituents and the contamination conveyance. The AAI inquiry must include "interviews of major occupants that are using, storing, treating, handling, or disposing (or likely to have used, stored, treated, handled, or disposed) of hazardous substances (or pollutants, contaminants, petroleum, and controlled substances, as applicable) on the property."⁹

Reviews of Historical Sources of Information (Proposed 40 CFR § 312.24)

The proposed AAI rule also requires a review of historical sources of information. This inquiry addresses "historical documents (that) may contain essential information regarding past ownership and uses of a property that may provide information regarding the potential for environmental conditions indicative of releases or threatened releases of hazardous substances to be present at the property."¹⁰ The records may include, but are not limited to, "aerial photographs, fire insurance maps, building department records, chain of title documents, and land use records."¹¹ The proposed rule states that the period for this review is "as far back in the history of the subject property as it can be shown that the property contained structures, or from the time the property was first used for residential, agricultural, commercial, industrial, or governmental purposes"¹² In other words, the historical review period should go back to the time when the property was first developed. The "first developed" language is used in the Brownfields Amendments and reflects the intent of the legislation.

As with the previous inquiry involving interviews with property owners and occupants, the historical review could provide the appraiser with information

6. See AO-9 for a discussion of the use of extraordinary assumptions in this context. Also discussed in Thomas O. Jackson, "Appraisal Standards and Contaminated Property Valuation," *The Appraisal Journal* (April 2003): 127-128.

7. *Federal Register* 69, no. 165 (August 2004): 52561.

8. *Ibid.*

9. *Ibid.*

10. *Ibid.*

11. *Ibid.*, 52579.

12. *Ibid.*

concerning the potential hazardous constituents that may be impacting the site. The appraiser should consider relying on the opinion of the environmental professional in this regard, however. The historical records may also be of use to the appraiser in understanding the use of and improvements to the subject property, which may be relevant to the property's environmental history and condition.

In appraising contaminated properties or properties that may be impacted by contamination, a useful and important first step is to prepare a written description of the property's environmental condition and history. This description is useful for the subsequent analysis of the impacts of the contamination on property value. It also sets forth the appraiser's assumptions concerning the history of the contamination (including the date of discovery of any contamination), its remediation status, and any regulatory compliance issues, all of which are considered relevant property characteristics in AO-9.

Searches for Recorded Environmental Cleanup Liens (Proposed 40 CFR § 312.25)

The proposed AAI rule requires a search for environmental cleanup liens against the subject property that have been filed or recorded. The proposed rule defines recorded environmental cleanup liens as "encumbrances on property for the recovery of incurred cleanup costs on the part of a state, tribal, or federal government agency or other third party," and it is noted that these liens "often provide an indication that environmental conditions currently or previously existed on a property that may have included the release or threatened release of a hazardous substance."¹⁵ For this inquiry, the rule recognizes that these liens can often be tracked efficiently and much less expensively by the purchaser than by the environmental professional, and so the search can be performed by either the property purchaser or the environmental professional.

Interestingly, a special type of lien, known as a "windfall lien," may be enforced by the EPA and the U.S. Department of Justice (DOJ) in order to capture some of the windfall gain to a property owner

(bona fide prospective purchaser) accompanying an increase in market value as a result of a federally funded cleanup of the property. As noted in EPA and DOJ documents, the "windfall lien provision (in the Brownfields Amendments) reflects Congress's intent that bona fide prospective purchasers should not be unjustly enriched and reap a windfall where taxpayer dollars are spent cleaning up the property and those taxpayer dollars lead to an increase in the fair market value of the property."¹⁴ This perspective is generally consistent with findings in the empirical literature on contaminated properties that subsequent to cleanup, previously contaminated properties regain their market value.¹⁵ This is also consistent with the recognition in AO-9 of the three stages of the remediation cycle: before, during, and after cleanup, and the distinct differences in environmental risks (stigma effects) at each stage.

Reviews of Federal, State, Tribal, and Local Government Records (Proposed 40 CFR § 312.26)

The proposed rule states that there must be an inquiry involving the review of various records related to "information regarding the use and occupancy of and the environmental conditions at the subject property and conditions of nearby or adjoining properties that could have an impact upon the environmental conditions of the subject property."¹⁶ Records to be searched include:

- Records of reported hazardous releases or threatened releases;
- Records of activities, conditions, or incidents likely to cause or contribute to releases or threatened releases, including landfill and other disposal unit records, storage tank records and permits, listings of sites identified as priority cleanup sites, and spill reporting records;
- Comprehensive Environmental Response, Compensation, and Liability Information System (CERCLIS) database, including sites on the National Priorities List (NPL) or Superfund list;
- Public health records or other government records of public risks;

13. *Ibid.*, 52562.

14. Susan E. Bromm (U.S. Environmental Protection Agency) and Bruce S. Gelber (U.S. Department of Justice), memorandum, 16 July 2003, "Interim Enforcement Discretion Policy Concerning 'Windfall Liens' Under Section 107(r) of CERCLA."

15. Thomas O. Jackson, "The Effects of Environmental Contamination on Real Estate: A Literature Review," *Journal of Real Estate Literature* 9, no. 2 (2001): 93-116.

16. *Federal Register* 69, no. 165 (August 2004): 52562.

- Emergency Response Notification System (ERNS) records;
- Registries or publicly available lists of engineering controls; and
- Registries or publicly available lists of institutional controls, including environmental land use restrictions.

These records could potentially provide much of the information on relevant property characteristics needed by the appraiser that are listed in AO-9, including accidental or permitted discharges, contamination constituents, liabilities for site cleanup (at least for NPL sites), and potential limitations on the use of the property due to the contamination and its remediation. This last element is important for appraising contaminated properties because of potential impacts on the highest and best use of the property. As stated in AO-9, in analyzing the highest and best use of potentially impacted properties, the appraiser must consider limitations due to the contamination, its remediation, and any legal use restrictions associated with the cleanup of the contamination. Specifically, the appraiser “*should consider the possibility that site remediation and any remaining limitations on the use of the site following remediation may alter or limit its highest and best use in the impaired condition.*” (AO-9, Lines 164-166)

Visual Inspections of the Facility and of Adjoining Properties (Proposed 40 CFR § 312.27)

The proposed AAI rule requires an inquiry that includes a visual, on-site inspection of the subject property and areas where hazardous materials may have been used or stored as well as inspections of adjoining properties (from the subject property or other vantage points, such as aerial photographs). Members of the Negotiated Rulemaking Committee that developed the proposed AAI rule pointed out that “on-site inspections of a property can provide the best source of information regarding indications of environmental conditions of the property.”¹⁷ Appraisers should see a parallel between the on-site inspection requirements for environmental professionals performing AAI inquiries and the importance of on-site inspections of subject properties as part of the appraisal process. Much information can be gained by visually inspecting properties for both purposes.

17. *Ibid.*, 52564.

18. *Ibid.*, 52580.

Specialized Knowledge or Experience on the Part of the Person Undertaking the Inquiry (Proposed 40 CFR § 312.28)

The proposed rule also requires specialized knowledge of the inquirer with respect to “the subject property, the area surrounding the subject property, the conditions of adjoining properties, and any other experience relevant to the inquiry, for the purpose of identifying conditions indicative of releases or threatened releases at the subject property.”¹⁸ The intent of the inquiry “is to ensure that any information or special knowledge held by the purchaser or property owner with regard to a property and the conditions or situations present at the subject property” is considered when an environmental professional renders an opinion concerning the environmental condition of the property. In other words, the environmental professional should make inquires of the owner or purchaser about special knowledge that he or she may have regarding environmental conditions of the subject property, since this information might not appear in the public records or other data sources. This might be roughly analogous to an appraiser interviewing the owner of the property under appraisal. It also suggests that the results of an AAI inquiry and opinion concerning the environmental condition of the property might be based on knowledge and information otherwise unavailable to the appraiser.

The Relationship of the Purchase Price to the Value of the Property, if the Property Was Uncontaminated (Proposed 40 CFR § 312.29)

In the proposed AAI rule, the central issue with respect to the appraisal community is the requirement for inquiry into the relationship of the purchase price to the value of the property, if the property was uncontaminated. As such, it will be discussed in more depth later in this column. Briefly, the AAI rule states that applicants for the CERCLA liability protections under the Brownfields Amendments

must consider whether the purchase price of the subject property reasonably reflects the fair market value of the property, if the property were not contaminated, [and] persons who conclude that the purchase price of the subject property does not reasonably reflect the fair market value of that property, if the property were not contaminated, should consider whether or not the dif-

ferential in purchase price and fair market value is due to the presence of releases or threatened releases of hazardous substances.¹⁹

As such, the proposed rule does not require a real estate appraisal, since it was determined that a formal appraisal is not necessary for the purchaser to make a general determination of whether the price paid for a property reflects its market value. The committee that formulated the AAI rule suggested that “such a determination may be made by comparing the price paid for a particular property to prices paid for similar properties in the same vicinity as the subject property,” since “the objective is not to ascertain the exact value of the property, but to determine whether or not the purchase price paid for the property is reflective of its market value.”²⁰

The Negotiated Rulemaking Committee appears to suggest that the valuation or appraisal problem they are asking the purchaser to address is actually less complex than what would be involved with a formal appraisal of a property. As discussed in previous “Environment and the Appraiser” columns, this is the opposite of what is actually the case with properties that may be impacted by environmental contamination. Rather than a simpler or less complex question, the analysis of the effects of contamination on the market value of real properties is a far more demanding and involved appraisal problem. It usually involves not one but two values (impaired value and unimpaired value) and the analysis of three types of effects (risk, cost, and use) in determining the extent of any property value diminution due to environmental contamination.

Commonly Known or Reasonably Ascertainable Information (Proposed 40 CFR § 312.30)

The proposed AAI rule also requires the applicant or environmental professional conducting the inquiry to “take into account commonly known or reasonably ascertainable information within the local community” concerning “releases or threatened releases at the subject property.”²¹ This information would be in addition to the data collected in the other inquiries. The commonly known information may be collected from the owner or occupant of a prop-

erty, members of the local community, including owners or occupants of neighboring properties to the subject property, local or state government officials, local media sources, and local libraries and historical societies.²²

The Degree of Obviousness of the Presence or Likely Presence of Contamination (Proposed 40 CFR § 312.31)

The proposed rule requires the person conducting the inquiries to “consider all the information collected during the conduct of the inquiries in totality to ascertain the potential presence of a release or threatened release,” and “assess whether or not an obvious conclusion may be drawn that there are conditions indicating a release or threatened release of hazardous substances.”²³ As such, this could be considered a capstone inquiry. To the extent an appraiser may rely on the opinions of the environmental professional conducting the investigations, this final criterion may provide an important indicator of the certainty and reliability of the opinions and, as such, might bear on the appraiser’s analysis of environmental risk (stigma) effects with respect to what is known about the contamination and the certainty of this knowledge.

Valuation Issues and Opportunities in the Proposed AAI Rule

There are numerous opportunities for the inquiries proposed in the AAI rule to provide the appraiser with information necessary to evaluate contaminated properties and the impact of contamination on their value. Many of the relevant property characteristics in AO-9 are also addressed in the AAI rule inquiries; if an appraiser is included in the process, the valuation of these brownfield properties would benefit from this information. A well-informed and reliable valuation of these properties in their “as is” or impaired condition would greatly benefit the purchaser and anyone with a financial or ownership interest in the properties. Purchase prices and environmental risks could be more accurately evaluated with the types of information required by the proposed AAI rule, if such information were made available to the appraiser and the appraiser were included in the process.

19. U.S. Environmental Protection Agency, 40 CFR § 312.29 (a) and (b), *Federal Register* 69, no. 165 (August 2004): 52580.

20. *Federal Register* 69, no. 165 (August 2004): 52567.

21. U.S. Environmental Protection Agency, 40 CFR § 312.30 (a) and (b), *Federal Register* 69, no. 165 (August 2004): 52580.

22. *Federal Register* 69, no. 165 (August 2004): 52567.

23. *Ibid.*, 52567-52568.

Unfortunately, the proposed AAI rule seemingly leaves the appraiser out of the process, even though the rule requires (1) an assessment of the difference between the fair market value of the property, assuming no contamination, and the actual sale price; and (2) a determination as to whether any difference is due to the effect of the contamination. The rule suggests that the purchaser consider the price paid for comparable properties in the area to determine the fair market value, assuming no contamination effects. For those familiar with the contaminated property valuation framework espoused in this column and elsewhere, the rule's suggestions have some relationship to parts of the framework.

First, the "fair market value, if the property were uncontaminated" could be the rule's proxy for the unimpaired value that is estimated by the appraiser through one or more of the three approaches to value (cost, income capitalization, and/or sales comparison) under the hypothetical condition that the property is uncontaminated.²⁴ Appraisers may use unimpaired comparable sales for this purpose, as is seemingly suggested in the rule, or may use other approaches, such as the income capitalization approach, a common and usually appropriate approach for income-producing commercial and industrial properties, as most of the brownfield properties are likely to be, or the cost approach, which is frequently an appropriate approach for specialized industrial properties, again like many brownfield properties are likely to be. Even when a sales comparison approach is used, though, the appraiser must be careful to use truly unimpaired sales. In areas with widespread contamination from a common source that may, for example, be conveyed through a ground-water plume, the seemingly unimpaired sales may not be unimpaired at all. Thus, the rule falls short in its suggested methodology for purchasers to determine their own unimpaired value.

Second, in the determination of the impaired value, the proposed AAI rule seems to suggest that the purchase price is a reasonable proxy. Most appraisers know that sale price and market value are not always the same. A particular sale price may not be an appropriate indicator of value if it is influenced by unusual motivations of the buyer or seller, nonmarket financing, government subsidies, or other nonmarket factors. All of these should be investigated. Also, market value is established by the interaction of a number of buyers and sellers, rather than one of each. Market value reflects the central tendency of the market, and that cannot be determined from one transaction but only by studying the market more broadly.

Advisory Opinion 9 and other sources categorize the effects of contamination on value as: cost effects, use effects, and risk effects. As explained in previous columns and in AO-9:

- Cost effects are deductions for costs to remediate a contaminated property to appropriate regulatory standards, recognizing that not all costs are recognized by the market as having an effect on value;
- Use effects are limitations on the highest and best use of properties that may be impacted by environmental contamination; and
- Risk effects are the effects on value due to the increased perceptions of environmental risk by relevant market participants.

The proposed AAI rule does not mention or address any these elements possible effects of contamination.

Conclusion

The proposed AAI rule has the prospective purchaser determine the impact of contamination on value, but provides incomplete guidance on how to make this

24. Jackson, "Appraisal Standards and Contaminated Property Valuation," 128-129.

determination. This serves no one's interests. The proposed rule misses an opportunity to take advantage of the considerable progress of the appraisal profession in recent years in developing a reliable framework for evaluating the effects of contamination on the value of real properties. It is hoped that the concerns expressed by the Appraisal Institute and others will be considered in developing a final AAI rule and that the rule establishes an appropriate framework whereby appraisers use the considerable environmental information collected as part of the other inquiries in the AAI rule to produce value estimates that assist the brownfields redevelopment process.

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