

Managing Environmental Risks Within Qualified Opportunity Zones and Brownfield Redevelopment

Qualified Opportunity Zones (QOZ) were created as part of bipartisan legislation in The Tax Cuts and Jobs Act of 2017 with the goal of stimulating investment in low income and rural communities. The act allows investors in these zones to benefit from deferred and delayed capital gain taxes. The US Internal Revenue Service has identified over 8,700 sites across the country as being eligible for QOZ benefits where there is investment in those properties. Many of these sites — traditionally referred to as “brownfields” — are contaminated. As QOZ investors seek to realize the benefits of investing in these properties, it is critical to understand and manage the potential costs and environmental risks associated with them.

Key advantages of brownfield sites

The US Environmental Protection Agency (EPA) estimates that there are more than 450,000 brownfield sites across the country. According to the EPA, “with certain legal exclusions and additions, the term ‘brownfield site’ means real property, the expansion, redevelopment, or reuse of which may be complicated by the presence or potential presence of a hazardous substance, pollutant, or contaminant. Cleaning up and reinvesting in these properties protects the environment, reduces blight, and takes development pressures off greenspaces and working lands.”



With many businesses seeking to “reshore” jobs and investments to the US and investigating higher-value alternative uses of existing properties, brownfield sites can represent a significant opportunity for some. For example, brownfields can:

- Provide a potential source of cash if their total value is accounted for and maximized. A University of Delaware study found that every dollar spent by the state on brownfield redevelopment returned \$17.50. Similarly, [the EPA reported](#) that through fiscal year 2018, \$16.86 was leveraged for each dollar spent by the EPA’s brownfields program.
- Be more attractive than traditional greenfield development (working with undeveloped land) because they may offer advantages of location and price. Brownfield sites are often located near — and provide easy access to — infrastructure and commerce.
- Provide for tax incentives and access to federal loans and grants if redeveloped.

Risk Management Implications

Most brownfield development projects focus on environmental issues during the acquisition stage. Typically, the first step involves environmental due diligence to identify and quantify environmental costs for inclusion in pro forma analyses and as part of negotiations for purchase and sale agreements (PSAs).

A successful environmental strategy should consider risks associated with all levels of development in a brownfield project lifecycle. These include:

- Stage 1 — Acquisition risks and needs:

- Manage known and unknown risks identified during due diligence.
- Provide greater certainty regarding pro forma cost assumptions.
- Provide certain assurances to the seller for environmental matters.
- Eliminate or reduce indemnity obligations.
- Eliminate or reduce the assumption of risk by developer.
- Manage risk associated with transaction documents (such as PSAs).

- Stage 2 — Redevelopment risks and needs:

- Integrate costs and risk management associated with redevelopment plans.
- Manage cost overruns associated with remediating known conditions.
- Facilitate or provide backup for cost collection under indemnity (amount and timing).
- Limit impact from discovered conditions and third-party claims.

- Stage 3 — Exit strategy risks and needs:

- Eliminate or limit indemnity and costs to developer and investors on exit.
- Provide assurance to other developers, homeowners, or tenants.



Risk Management Solutions

A number of risk management tactics should be addressed together to target exposures across the project life cycle. These include:

1. Contractual protection: A PSA is often considered the first line of risk management defense for both buyers and sellers. Several provisions and protections are typically woven into PSAs, including indemnities, representations and warranties, performance standards on disclosure, cost allocation, and purchase price adjustments. The selection of legal counsel with environmental experience on property transactions is a critical first step to create a PSA that can help minimize a party's potential exposure to environmental risks.

During development and operation, owners will enter into a variety of agreements with contractors, joint venture partners, and other stakeholders. Allocation of risk is critical in these documents, as is specifying insurance requirements applicable to contractors and subcontractors on specific projects.

2. Third-party liability transfers: In traditional transactions, the buyer and seller negotiate the allocation of environmental risks. Brownfields transactions typically involve the assumption or apportionment of multiple and often complex risks. In many cases, both parties want cost certainty and neither party wishes to assume environmental liabilities, preferring to leave the environmental issues to another party so they can focus on their own core competencies.

Environmental engineering and consulting firms can help provide some solutions in third-party liability transfers. These companies have embraced two approaches:

- Under a guaranteed fixed-price contract, the buyer or seller retains liability, but the consultant provides a single price to complete remediation and achieve closure consistent with the intended development and project schedule. This provides cost certainty around environmental remediation costs.
- In an environmental liability buyout, the consultant contractually assumes environmental liabilities from both the buyer and the seller. A liability transfer agreement (LTA) is executed to complete the transfer of the environmental liabilities. The LTA provides for a transfer of risk and can include the consultant assuming responsibility directly with regulatory agencies for outstanding orders and decrees. This solution involves pre-funding the consultant's liability at the time the transaction is completed.





Environmental Insurance

Various environmental insurance products can be used on brownfield projects to help manage an array of environmental risks for buyers, sellers, and/or consultants.

Pollution legal liability (PLL) insurance can help protect against adverse financial consequences related to the discovery of certain unknown conditions such as:

- Environmental remediation cleanup costs (on- and off-site).
- Third-party bodily injury.
- Third-party property damage.
- Legal defense expense.
- Natural resource damage claims.
- Diminution in value (third party).
- Development soft costs due to delay.
- Business interruption.

Any known conditions can be precisely and narrowly defined to help maximize coverage. A PLL policy can be assigned to or allow for the addition of multiple stakeholders, including the buyer, seller, and future landholders to help facilitate the future sale and divestiture of a property.

Contractors pollution liability (CPL) insurance is often required of contractors and subcontractors doing work on site in the event they exacerbate a preexisting pollution condition or create a new one that requires cleanup or results in third-party claims. There is often concern about the adequacy of contractor coverage, and also whether claims on other projects might erode available insurance limits. It is common for owners to secure a CPL policy for a project, which protects the owner and provides coverage for contractors and subcontractors. The cost for this insurance can be offset in part or in whole by having contractors and their subcontractors net out allocation of their corporate CPL program to the bid.

A cost cap policy can provide protection against cost overruns associated with known conditions, which are typically excluded from the PLL policy. During negotiations, the known conditions are identified, a cost is assigned for their cleanup, and responsibility is allocated in the PSA. The cost cap policy can then provide coverage if:

- The known contamination is greater in volume than expected.
- The degree of contamination is higher (for example, soil that was expected to be non-hazardous turns out to be hazardous).

- Previously unidentified contaminants that affect treatment and disposal costs are discovered.
- The amount of time for remediation is longer than anticipated, resulting in increased variable and non-variable costs to be incurred in connection with the remediation.
- The EPA, state, or other government agencies mandate a change in remedy and/or enhance a cleanup standard, which could increase costs.

Regulatory Considerations

According to the EPA, government assessments of brownfield sites typically describe:

- The background and current conditions of the site and include maps, previous uses, assessment findings, and reuse goals.
- Applicable regulations.
- Cleanup standards and an evaluation of cleanup alternatives, as well as a recommended remedial action.

Financial Feasibility

To minimize expenses and maximize revenue from brownfield sites, buyers and sellers should understand how to manage cost uncertainty associated with environmental risk factors. This involves identifying the best uses in concert with recovering salvage values and taking advantage of available tax incentives including the ability to defer and delay the payment of capital gains when investing in a QOZ.

Environmental outcomes can be difficult to forecast, both in terms of cost and time. For example, the pro forma net present value (NPV), which is commonly used in evaluating brownfield sites during a transaction, is highly sensitive to cost assumptions and related likely variances in them. Historically, some development has been halted because of financial uncertainties. Lenders often require environmental insurance to secure their interests in the event that pollution is discovered. Among other variables, an assessment and decision about a project's viability and forecast return on investment should take into account:

- A full cost accounting of environmental risks for the project as related to purchase and sale agreement negotiation, field execution, and successful exit strategy.
- Variances that may occur in environmental costs, as well as their timing.

- Environmental issues that may affect site redevelopment plans, end uses, and usable acreage calculations.
- Risk management processes used to minimize or eliminate variances, including proper contract negotiation, environmental insurance, subcontractor insurance requirements, field management practices, and exit strategy.
- The approach of including the results of a risk management assessment with the pro forma development could help to maximize the total project return.

Conclusion

Cost uncertainty and other potential environmental exposures associated with QOZ brownfields often can be managed by a careful analysis of risks from acquisition through exit strategy, and by the use of appropriate risk management strategies. Environmental risk transfer solutions, including PSA negotiation, environmental insurance, guaranteed fixed-price contracts, and environmental liability buyouts can help. With the appropriate risk management mechanisms in place and buyers who can realize the best usage, a QOZ brownfield project can represent a significant business opportunity.

About this Briefing

This briefing was published by Marsh's Environmental Practice, which specializes in risk management solutions to a range of environmental concerns. In addition to cleanup and third-party liability, pollution insurance can provide valuable benefits such as coverage for legal defense costs, emergency response costs, and business interruption. Pollution insurance can be packaged with other insurance policies to cover other exposures related to pollution events.

For more information about Marsh's Environmental Practice and other solutions from Marsh, visit marsh.com, or contact your local Marsh representative.

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