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“Beware of Strangers: Third Party Reliance Risks for Environmental Professionals in Transactional Situations” (A Risk Primer and Some Initial Suggestions)

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INTRODUCTION

Consider the following situations:

An environmental consultant is hired *by a seller* on short notice to provide an environmental assessment of a property pending a large transaction *for the seller*. Several apparent errors are made and contamination is not noted in the environmental report from the consultant. The buyer is provided with copies of the environmental report by the *seller*. The buyer (now the new property owner) discovers the errors as the environmental regulators undertake investigations and enforcement actions. A lawsuit follows from the buyer against the environmental consultant.

Even though there was no contract between the consultant and the buyer, and even though the consultant did not give its report directly to the buyer, the buyer was allowed to proceed directly against the consultant.

In another situation, a consultant is called in for a small job (approximately \$1,200 in fees) by a property owner entering into a property lease transaction with another firm. In this case, the owner/lessor and lessee both have capable in-house engineering staff. The consultant’s client (the owner) gives the consultant’s report to the lessee in the transaction.

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A serious problem related to the consultant's report ensues, and the owner/client sues the consultant. The defending consultant initially prevails, although extensive subsequent proceedings result in a finding of liability on the part of the consultant to its client. The liability of the consultant is limited to the contractually agreed-to maximum. Then, the lessee (who paid no fee to the consultant, who had no contract with the consultant, and who received the report from the consultant's client) asserts a claim directly against the consultant.

Ultimately, all available insurance proceeds are exhausted and a payment in excess of the insurance (a seven-digit number) is made.

THE PROBLEM OF THIRD PARTIES AND CONSULTANT REPORTS

Both of these stories are sanitized and modified to prevent the identification of the real situation, but both represent the very real problems that can arise in terms of third-party claims. They both present chilling situations illustrating a troubling answer to this question: How can an environmental professional be liable to someone with whom the professional has no signed agreement, from whom the professional has received no payment, and to whom the professional has never communicated his or her findings? To be certain, there was a historical requirement for privity of contract in order for one person to assert a claim against another in these types of situations under contract. At the same time, courts labored to find ways in which a contract could be said to create rights in a third party. This is, as lawyers say, "hornbook law," or axiomatic.¹ However, contract actions are not the only way in which liability can arise.

Tort liability to third parties relative to the provision of services can arise readily, and this, too, can be said to be axiomatic, or "hornbook law."² It is this area of tort law which can create the kind of unintended results discussed at the outset of this introduction, and it is this area of tort law upon which we will focus in the present brief article.

THE RESTATEMENT POSITION

The American Law Institute (ALI) has, for decades, for ill or good, purported to "restate" the law in various areas as a means of saying what the law seems to be and, perhaps more importantly, what it should be (at least in the minds of the participating legal scholars). Courts have turned to the massive work of the ALI and its various committees in situations where there

¹ Corbin, *Contracts*, 1 Vol. Ed., §§772 et seq., West, 1952.

² Prosser, *Law of Torts*, 4th Ed., §104 at p. 679, West, 1971.

was no ready precedent, or in situations where a court wanted to follow a new line of thought.

In order to more readily understand how environmental professionals can find themselves with what are essentially “unintended clients,” we need to see how the liability analysis presented in the Restatement of Torts³ establishes such liability. The Restatement rule can apply to any sort of professional.

THE RESTATEMENT BEGINS TO INFLUENCE THE LAW

A 2001 case from Oklahoma articulates the rule as well as any, and is instructive to us here. In this case, the court was confronted with the problem of whether or not someone could rely upon an Arthur Anderson accounting report, even though the report was not prepared for this particular entity and its shareholder.

In other words, as was the case with our two illustrations at the outset of this paper, there was no engagement agreement between Arthur Anderson and the plaintiff(s) in this case. But there was, according to the court, liability. The court looked to the analysis of third-party liability found in the Restatement, and was persuaded to follow it. In pertinent part, the court said:

Under the Restatement test, an auditor” (or, we might also say for our purposes, an environmental professional) “would be liable to a limited group of people embracing (1) those for whose guidance the auditor intended to supply the audit data and (2) those to whom the auditor knows his client intended to supply the audited financial statements” for reliance purposes.⁴

The court stressed that a key component of this analysis was the fact that it was indeed foreseeable to the accounting firm that its reports would be received by and relied upon by third parties, people with whom it had no engagement and with whom it had no “privity of contract.” This “foreseeability” aspect of the analysis is key to our understanding of the problem, and to articulating a solution to the problem.

A pair of Georgia cases are even more instructive.

In the first case, *Robert & Co. Assoc. v. Rhodes Haverty Partnership*,⁵ the issue was whether or not an engineering firm that had issued a building condition report or survey could be liable to a third party for matters in the report. The court looked with favor on the Restatement position discussed above and held as follows:

³ *Restatement of Torts*, 2d, §552, (1977)

⁴ *Stroud v. Arthur Anderson and Co.*, 37 P.3d 783 at 794 (2001). Lawyers are subject to third-party risks as well. See: *Petrillo v. Bachenberg*, 139 N.J. 472 (1995).

⁵ 250 Ga. 680 (1983).

(O)ne who supplies information in the course of his profession has a duty of reasonable care and competence to parties who rely upon the information in circumstances in which the maker was manifestly aware of the use to which the information was to be put and intended that it be so used. This liability is limited to a foreseeable person or limited class of persons for whom the information was intended. In making a determination of whether the reliance by the third party is justifiable, we will look to the purpose for which the report or representation was made. If it can be shown that the representation was made for the purpose of inducing third parties to rely and act on for reliance, then liability to the third party can attach. If such cannot be shown, there will be no liability in the absence of privity” (meaning: a direct contractual relationship) “willfulness or physical harm or property damage. The additional duty which this rule imposes may be, of course, limited by appropriate disclaimers which would alert those not in privity with the supplier of the information that they may rely upon it only at their peril.

So, although the Court held open the possibility of broad liability to third parties absent a contractual relationship (privity), willfulness or physical harm or property damage, the Court created a way for professionals to control much of the economic damage exposures to third parties. This is no small matter.

Much of the total risk faced by environmental professionals is likely to be economic in nature, so-called “economic damages” or “economic loss”⁶ and not necessarily classified as property damage or bodily injury. Much more probable is the possibility that a failure to detect some condition with result in the unintended purchase of property that turns out to have an environmental problem.

The resulting lessening of market value and the accompanying unexpected cost of clean-up (along with possible CERCLA liability,⁷ etc.) is the more likely difficulty. Unfortunately, clients are demanding that environmental professionals assume these economic risks (which have previously been risks borne by clients as part of the entrepreneurial function).⁸ The damages represented by such risks can be potentially catastrophic losses for all but the largest of firms.

The more recent Georgia case of *Martha H. West Trust v. Market Value of Atlanta*⁹ provides a more fulsome illustration of the dilemma the professional faces in term of third-party risks. The Wests (cotrustees of the West Trust), bought a condominium from the Ryans. Before the sale, Ryan had the property appraised by Market Value of Atlanta, Inc., and by Daniel Fries and Associates,

⁶ See *Design-Build for the Design Professional*, G. William Quatman, §21.03 at page 338 *et seq.* Aspen Publishers, 2001.

⁷ “The Innocent Landowner Defense and Phase I Environmental Site Assessments,” Karl J. Duff, Chapter 5, *1994 Wiley Construction Law Update*, Overton and Sweeney, Eds., pg. 83 *et seq.*, John Wiley and Sons, New York (1994).

⁸ “Risk Shifting for Environmental Professionals: A Primer on Standards of Care and Indemnities,” Karl J. Duff, *14 Environmental Claims Journal No. 3, Summer* (2002) at pg. 301 *et seq.*

⁹ 262 Ga. App. 90 (2003).

Inc. Neither Market Value nor Fries knew Ryan was about to sell the condo (to settle a partnership debt between Ryan and West), and neither knew that Ryan would provide their reports to a third party. Each appraisal report contained language requiring the appraiser to give its prior written consent *before* Ryan could distribute the report to anyone else other than a specified list of entities (mortgage company and assigns, for example).

The West Trust bought the condo for \$260k (the lower of the two appraisals, which was provided by Market Value of Atlanta's appraisal). The new West Trust owner invested some \$15,000 in improvements. At that point, the West Trust tried to sell and was told by a Realtor that the real market value was about \$235,000. The property eventually sold for some \$228,000.

This is aptly analogous to what might happen to an environmental professional whose environmental report missed some contamination and resulted in a lower value of the property to the new owner. Remember, a Phase I report does not warrant that all environmental problems or issues have been (or could be) identified. Given the absence of testing (either laboratory or Phase II invasive testing) under the current ASTM 1527 (2000) protocol.¹⁰ It is certainly possible that a properly performed Phase I could be used to assist in deciding to go forward with a decision to purchase a property only to discover there was an environmental problem.

In the instant case, West brought suit against Ryan, Daniel Fries and Associates, and Market Value. The suit alleged that Ryan had fraudulently induced the appraisers to overinflate the value of the properties. Suit was filed against the appraisers for professional negligence.

Daniel Fries and Associates escaped from the litigation because it was the Market Value report that the West Trust relied on, not the higher number in the Fries report. The trial court also found that Market Value DID NOT OWE A DUTY TO WEST, OR BREACH ANY STANDARD OF CARE IN PERFORMING THE APPRAISAL. The Court looked to the prior *Robert & Co. Assoc.*¹¹ case and adopted the Restatement approach, as well as the prior court's indication that this type of risk could be controlled with appropriate disclaimers.

Thus, there is real risk of liability to third parties, but that risk may be managed or mitigated by the appropriate use of specific risk management techniques. The balance of this brief article will discuss such techniques.

¹⁰ The reader is cautioned that the U.S. EPA, pursuant to statutory mandate is (some might say "at last") promulgating a standard for what is an appropriate level of due diligence relative to the innocent landowner defense under CERCLA. Note the proposed rule published August 26, 2004, at 69 Federal Register No. 165, pg. 52541 *et seq.*

¹¹ Note 5, *supra*.

**UNDERSTANDING REALITY IN TRANSACTIONS:
ENVIRONMENTAL PROFESSIONALS MUST DEAL
WITH THIRD PARTIES**

Given that the third-party risk is real, and is apparently here to stay, it is necessary to identify the third parties with whom the environmental consultant is likely to deal in a transaction and assess the risks associated with those relationships. For example, environmental consultants find themselves dealing with the following “client-related” third parties:

- Accountants
- Financial advisors
- Legal counsel
- Affiliated entities (parents, subsidiaries, etc.)
- Risk managers and insurance brokers
- In some cases, public relations firms

All of these parties are either employed by, or acting on behalf of, the environmental consultant’s client. It is almost inevitable that in some cases the environmental consultant’s work product will find its way to one or more of these groups of people. With this in mind, we turn to our next group of third parties, those we might consider to be outside the world of the client, and who may well have business interest positions actually or potentially opposed to the client, or who might even take adversarial legal positions:

- Lenders (and the counsel of same)
- Buyers of the client’s property (and the consultants and advisers and counsel of same)
- Entities selling property to the client (and the consultants and advisers and counsel of same)
- Tenants/lessees (and the consultants and advisers and counsel of same)
- Governmental regulators

From the standpoint of the environmental consultant, where are the *most likely* sources of claims from third parties? It may well be that the environmental consultant and its counsel¹² concludes that lenders, tenants, buyers, and/or sellers on the opposite side of the transaction from the environmental consultant’s client (as the case may be) offer the greatest opportunity for third-party transaction risks. If this is so, then what steps can the environmental consultant undertake to manage these transaction risks?

Any steps to manage these risks must at the least address the issues created by the Restatement’s articulation of third-party liability. They must

¹² The reader is directed to the disclaimer at the end of this paper.

also be designed for administrative workability by the staff of the environmental consultant, must incorporate procedures that are not overly onerous or offensive to the potential clients who must react to them, and must be reasonable.

THREE PRONGS OF LIABILITY

If we look closely at the Restatement requirements set out above, we can see that there are three key elements in the liability equation. First, it must be *foreseeable*, or even intended, that the environmental consultant's report will be delivered to someone other than the client (the "third-party recipient"). Second, this third-party recipient must rely on the report. Third, it must be foreseeable or even intended by the environmental consultant that the third-party recipient will, upon receipt of the report, rely upon the report.

If these three tests are met, it is a fair reading of the Restatement's analysis to suggest that the environmental consultant will have potential liability to both the intended recipient (the client of the environmental consultant) and the third-party recipient(s) that the environmental consultant foresaw or should have foreseen as receiving the environmental consultant's work product, and who (again foreseeably) relied upon that work product.

It is apparent, then, that the primary focus of sound risk management efforts relative to this third-party liability risk is to limit, control, or prevent altogether the distribution of the work product of the environmental consultant to these targeted third parties. This is most efficiently done by contract provisions.

DESIGNING CONTRACT DEFENSES

Prudent risk management along the lines suggested above would suggest drafting language that would provide the following contractual defenses:

- The agreement would make it clear that the environmental consultant's work product is for the sole and exclusive use of the client in connection with the transaction, and no one else;
- The client would agree that it would not distribute the environmental consultant's work product to the targeted (restricted) third parties *for reliance purposes* until and unless the third party first signed an agreement ("Secondary Client Agreement," discussed below) addressing key risk issues for the environmental consultant;
- The client would agree that if it distributed the environmental consultant's work product to third parties for anything other than reliance (i.e., "informational purposes only and not for reliance"), the client would affirmatively undertake certain disclaimers relative to such

nonreliance third-party disclosures to assure that the third party did not rely upon the environmental consultant's work product.

There are two other issues that experience indicates may arise and that should be dealt with in advance by these contract terms and conditions. First, the environmental consultant may face an actual or potential conflict of interest relative to the disclosure of client-related information and environmental consultant work product incorporating such information to a third party; this is exacerbated by the probability that the third party has interests that are (or may become) adverse to those of the environmental consultant's client.¹³ Second, in today's cyber economy, the report may be furnished to the client (or third party) electronically, thus creating previously ill-considered risks. We will look first at the issue of a conflict of interest.

CONFLICTS OF INTEREST

The environmental professional authoring a report may well have a professional designation: Professional Engineer, Professional Geologist, Certified Industrial Hygienist, etc.¹⁴ If so, the relevant professional canons of ethics may well prohibit "serving two masters." If the environmental consultant's client is a borrower and wants to provide a copy of the environmental consultant's report to the lender for the transaction relative to which the environmental consultant's work product is prepared, there is a fundamental adversity of interest.

In such situations, it will be critical to have the client waive in writing in advance any such conflict of interest in the event that the client wishes the environmental consultant to disclose its reports to a third-party. Similarly, the agreement between the environmental consultant and the third-party recipient ("Secondary Client Agreement," discussed below) must also address this issue. In addition, the inclusion of the standard disclaimer in construction documents that contractors and the like do not rely on any consultant materials would be an important risk management tool.

ELECTRONIC COPIES

The provision of electronic copies of reports in today's cyber-economy raises the risk of unauthorized (and potentially undetectable) modifications

¹³ For example, borrowers and lenders would be on the opposite sides of a foreclosure situation.

¹⁴ The pending EPA Due Diligence rule cited above in Note 10 would set specific requirements for the definition of Environmental Professionals who could sign reports. In this author's view at least, such requirements, if finalized as proposed, would significantly increase the applicability of professional rules of conduct and ethical behavior in term of perceiving and addressing potential and actual conflicts of interest.

of environmental reports by third parties once the report has been transmitted by the environmental professional.¹⁵ Therefore, the consultant's terms and conditions should address this situation and state that the hard copy is (and will remain) the definitive report of the consultant.

SECONDARY CLIENT AGREEMENTS

Once the environmental professional has established acceptable terms and conditions with its client relative to the agreed-to circumstances for any disclosure of the professional's work product to a third party, the environmental professional must also be ready to provide a document under which such disclosure could take place. Since the early 1990s, beginning at Law Companies Group, Inc. in Atlanta, this document has been referred to as a Secondary Client Agreement.

The environmental professional should first obtain authorization from its client (Primary Client) to disclose the professional's report to third party, provided that the third party (the Secondary Client) agrees to the professional's third party disclosure terms and conditions (the Secondary Client Agreement). The Secondary Client Agreement can be as short as one page and should:

- Address conflict of interest issues;
- Impose prohibitions upon subsequent distribution by the Secondary Client absent the prior written approval of the professional (which will be provided only upon conclusion of satisfactory disclosure terms similar to the Secondary Client agreement);
- Establish a normal standard of care;
- Refer to and incorporate any limitations in the use of the report as agreed between the professional and its Primary Client so that the same limitations apply to the Secondary Client;
- Establish an agreed-to limitation of liability between the environmental consultant and the Secondary Client.¹⁶

CONCLUSIONS

The environmental professional should be wary of risks to third parties in today's transactional workplace. Appropriate safeguards should be established in terms and conditions with the clients of the environmental professional that

¹⁵ The author has already seen one instance in which an environmental professional's report (which included the firm's letterhead on the electronic copy) was unscrupulously modified to delete references to environmental issues in order to mislead a lender.

¹⁶ For an excellent discussion of the importance of limitations of liability for professionals, see Lawrence D. Young, "Limitations on Design Professional Liability," *1998 Wiley Construction Law Update*, Chapter 3, pg. 55 *et seq.* (1998).

prohibit the disclosure of the professional's work product to third parties unless certain contractually-specified conditions are met.

This should help trigger a Restatement-based defense: it was not at all foreseeable that some third party would receive the professional's report without the professional's prior written consent and without the establishment of acceptable terms and conditions in advance between the professional and such third party. Indeed, such an action was specifically prohibited by the professional's contract with the client.

If such an unauthorized disclosure occurred and some third party was able to successfully mount some claim directly against the environmental professional despite the lack of foreseeability, then the professional should at least have a colorable claim for indemnity against its client for breach of contract in the amount of the professional's liability to the third party. This analysis seems correct, but at present the author is unaware of any case that so holds.

Hopefully, this article will trigger action on the part of the environmental consultant and its risk manager, broker, and counsel, to analyze these third-party risks and to determine what sort of preventative actions might be appropriate to the environmental professional's situation.

USE LIMITATIONS

1. These materials are intended only to stimulate thought, dialogue and risk analysis on the part of readers, as well as the Counsel, Brokers and Risk management personnel of the reader (all collectively referred to as: "the Reader"). No representation or warranty is made or intended that following these suggestions will successfully address particular risks. These materials are not intended to be a comprehensive catalogue of risk issues. The Reader must seek assistance from its own team of advisors, including locally-licensed Counsel, Brokers and Risk Management personnel on a case-by-case basis.
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