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Lisa J. Hamm Winnenauer

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TO TELL OR NOT TO TELL: LATENT ENVIRONMENTAL DEFECTS AND THE DOCTRINE OF CAVEAT EMPTOR IN REAL PROPERTY SALES

by Lisa J. Hamm Winnenauser

Greenwood Mills, Inc. v. Russell Corp. is a case arising from an aborted real estate transaction. Its primary significance lies in the court’s application of the caveat emptor doctrine (doctrine) to the purchase of commercial property possessing latent environmental defects.

The use of the doctrine in this case is important for several reasons. First, it controverts a growing trend abandoning the doctrine in favor of an emphasis on good faith and ethical dealing. Second, by finding that information concerning the existence of environmental defects was reasonably available to the buyer in this case, the court may be requiring buyers to do much more than physically inspect a property prior to making an offer in order to avoid a finding that they failed to meet their duty to investigate as it relates to latent environmental defects. Finally, this court’s holding may impact the usefulness and value of option contracts for the purchase of commercial property.

I. FACTS AND HOLDING

In September 1988, Greenwood Mills (Greenwood) decided to sell its Liner textile plant located in Orangeburg County, South Carolina. At that time, the property had a history of environmental problems, including wastewater treatment violations which had led to a consent order with the South Carolina Department of Health and Environmental Control (DHEC).

Russell Corporation (Russell) contacted Greenwood in August 1989 concerning its potential interest in acquiring the property and arranged a site visit. Prior to its first site visit, Russell’s Director of Environmental Affairs contacted the DHEC to inquire about the plant and was informed that while there had been violations in the past, Greenwood’s wastewater treatment facilities now met DHEC standards. Russell representatives then made two site visits to the plant in early September.

After the first site visit on September 6, 1989, Greenwood informed Russell that Sara Lee, Russell’s major competitor, was seriously interested in the property. Greenwood representatives made a second site visit on September 11, and on September 12 wired Greenwood $600,000 to hold the property. In a letter dated September 18, Greenwood acknowledged receipt of the deposit, describing it within the letter as “non-refundable.” The letter also included information on nine items Russell might wish to investigate and a general invitation to “kick the tires” yourselves.

Greenwood also enclosed with the letter a draft purchase agreement, which Russell did not sign. Russell then hired a consultant to perform a full environmental audit of the property.

While the environmental audit proceeded, Russell’s Director of Environmental Affairs had an opportunity to view some of Greenwood’s environmental records during a third site visit on October 23, 1989. In addition, the DHEC granted Russell access to its Greenwood files after receiving a Free-
dom of Information Act request from Russell.\textsuperscript{18} From the DHEC files, Russell learned for the first time that groundwater on the property was contaminated.\textsuperscript{19}

On November 2, 1989, Russell faxed to Greenwood a copy of the documents it had uncovered and indicated it would probably want its deposit back.\textsuperscript{20} Greenwood's sales agent requested Russell wait until it received the final results from its environmental audit prior to reaching a decision concerning purchase of the property.\textsuperscript{21}

The environmental report was received on December 14, 1989.\textsuperscript{22} The report indicated that substantial contamination existed, the cleanup cost of which could not be accurately predicted.\textsuperscript{23} By letter dated December 19, 1989, Russell informed Greenwood that the deal was off.\textsuperscript{24}

Greenwood brought a diversity suit against Russell in South Carolina federal district court to obtain a declaratory judgment confirming its right to retain the $600,000 deposit paid by Russell.\textsuperscript{25} Russell asserted counterclaims of fraud, misrepresentation and rescission of contract based on mutual mistake.\textsuperscript{26} After trial, the jury found for Greenwood.\textsuperscript{27} After the court denied Russell's motions for JNOV or a new trial,\textsuperscript{28} Russell appealed.\textsuperscript{29}

The Fourth Circuit affirmed the lower court's decision, holding that under South Carolina law "[a] seller does have a duty to disclose 'an artificially created, and concealed, unstable condition,'"\textsuperscript{30} but only if "the seller...know[s] that the material facts are beyond 'the reach of the diligent attention, observation and judgment of the purchaser.'"\textsuperscript{31}

II. LEGAL BACKGROUND
Caveat emptor or "[l]et the buyer beware... summarizes the rule that a purchaser must examine, judge, and test for himself."\textsuperscript{32} The Restatement (Second) of Torts imposes liability for physical harm on a seller when the seller knows or should know of the existence of a latent, dangerous condition which involves an unreasonable risk of harm; the seller does not disclose the condition to the buyer; and the seller has reason to believe the buyer will not discover the harm.\textsuperscript{33} The rule is applied "... when there exists in the property which is the subject of a sale latent defects or hidden conditions not discoverable on a reasonable examination of the property."\textsuperscript{34} In such situations, "the seller, if he has knowledge thereof, is bound to disclose such latent defects or conditions to the buyer, and his failure to do so may be made the basis of a charge of fraud."\textsuperscript{35} Liability will be imposed, however, only if the buyer has satisfied his duty to inspect the property.\textsuperscript{36}
Many courts do not recognize the doctrine, preferring to impose upon the seller the duty to act in good faith. A large number of states, however, still adhere to its basic tenets. The instant case was decided under South Carolina law, which provides that "[a] seller does have a duty to disclose an artificially created, and concealed, unstable condition," but only when "the material facts are beyond the reach of the diligent attention, observation and judgment of the purchaser."

There is little case law available specifically on the subject of the duty to disclose defects relating to environmental issues. The few opinions that can be found suggest the law in this area is nowhere near settled. Some states have permitted buyers to seek relief for latent environmental defects under a variety of common law theories, including nondisclosure of latent defects, negligence, strict liability, breach of warranty or contract, and breach of indemnity agreements.

Other states, including Missouri, have enacted statutory provisions requiring sellers to disclose the presence of contamination or other latent environmental defects on property. Even so, requirements from state to state vary significantly. In those states where statutory provisions do exist, generally the buyer is not permitted to void the sale and, as a result, ends up owning the contaminated land.

III. THE INSTANT DECISION

In determining that Greenwood was entitled to retain the $600,000 deposit paid by Russell, the court emphasized the fact that "Russell got exactly what it bargained for here: an option contract." The court went on to recognize that "placing the deposit allowed Russell to conduct a thorough environmental investigation and avoid the losses it might well have sustained if it had prematurely entered into a purchase agreement."

The court rejected Russell's argument that Greenwood had a duty to disclose its environmental problems and that its failure to disclose rendered the transaction unenforceable. The court held that under South Carolina law "[a] seller does have a duty to disclose an artificially created, and concealed, unstable condition" but only when "the material facts are beyond the reach of the diligent attention, observation and judgment of the purchaser."

The court noted the fact that Russell, like Greenwood, was a textile manufacturer and emphasized that "Russell could not have been surprised to learn that textile production involves substances which can lead to environmental hazards if not handled properly" and that Russell knew "such hazards would not be discernible through mere visual inspection." The court went on to suggest that a review of Greenwood's files and other public records would have revealed "the full extent of the problems," thereby satisfying the requirement that such facts were "reasonably available to Russell."

IV. CRITICAL ANALYSIS

The Fourth Circuit based its holding that Greenwood had no duty to disclose latent environmental defects to Russell on the fact that the transaction did not involve a contract for purchase of real estate, but rather an option contract in which "Russell got exactly 37 See supra, note 4.

38 See, e.g., Philadelphia Elec. Co. v. Hercules, Inc., 762 F.2d 303, 312 (3d Cir. 1985) ("As to sales of land this rule has retained much of its original force."); Adler v. Parkinson, 581 So.2d 1073, 1075 (Fla. 5th Dist. Cir. 1991) ("Florida courts appear reluctant to vitiate agreements when the complaining party is, either through education or experience, in a position which renders his claim of error particularly difficult to rationalize, accept or condone."); Futura Realty v. Lone Star Parkerson, 180 S.E.2d 208.

39 See supra, note 4.

40 Calenda v. Traczy, 93 S.E.2d at 128.

41 See generally Phelan, supra, note 3.

42 See supra, note 43.


44 Id. at n.118 (quoting Lawhon, 180 S.E.2d at 208).

45 Id. at n.134 (quoting Lawhon, 180 S.E.2d at 208).

46 Id. at n.134 (quoting Lawhon, 180 S.E.2d at 208).

47 Id. at n.134.

48 Greenvood, 981 F.2d at 150.

49 Id. at 150.

50 Id. at 150.

51 Id. at 150.

52 Id. at 150.

53 Id. at 150.

54 Id. at 150.

55 Id. at 150.

56 The court's holding that Greenwood's tort claim for auction losses is superseded by its contract claim for retaining Russell's deposit is not particularly controversial, and, therefore, is not discussed in the text of this note. Some scholars have suggested that, in the struggle between tort and contract law, the law of contract is losing; see GRANT GILMORE, THE DEATH OF CONTRACT 55-103 (1974); William L. Prosser, The Borderland of Tort and Contract, in SELECTED TOPICS ON THE LAW OF TORTS 380, 427-428 (1954); Elizabeth Cumming, Balancing the Buyer's Right to Recover Precontractual Misstatements and the Seller's Ability to Disclaim Express Warranties, 76 MINN. L. REV. 1189 (1992).

Nonetheless, the result of the instant case is consistent with justice and equity. Notwithstanding the inherent conflict within its complaint, the court rejected Greenwood's claim of negligent misrepresentation, and held Greenwood's reliance on Russell's February 1, 1990 target date for moving in was "plainly unjustifiable." Greenwood, 981 F.2d at 152. Greenwood knew at least a month before the auction that Russell had serious concerns about environmental problems. Greenwood, 981 F.2d at 149. On November 2, 1990, Greenwood's sales agent requested Russell refrain from making a final decision until the final results of its environmental audit were received. Greenwood, 981 F.2d at 150. The final report was not received until December 14, 1989, more than a week after the auction. Greenwood, 981 F.2d at 150. In addition, some significance should be placed on the fact that the contract drafted by Greenwood and forwarded to Russell along with a letter confirming receipt of Russell's deposit on September 18, 1989, almost three months prior to the auction, was never signed and returned.
what it bargained for. An equally strong argument, however, can be made that Russell did not get what it bargained for. It paid $600,000 to hold what it presumed was a piece of property it was interested in purchasing. It can be inferred from Russell’s decision not to proceed with the purchase after it received the environmental report that it was never interested in buying contaminated property.

The court also suggests that, through the option contract, Russell avoided losses it might otherwise have sustained by prematurely entering into a purchase agreement. The court does not address the $600,000 Russell lost by entering into an option contract it presumably never would have entered into had it known about the latent environmental problems, nor does it mention the funds spent by Russell on the environmental audit which revealed the serious nature of problems at the plant indisputably already known by Greenwood.

It should be remembered that Greenwood had revealed to Russell that Sara Lee was seriously interested in the property, obviously intending to apply pressure on Russell to move quickly or risk losing the property to a competitor. In fact, Russell made its deposit in response to a recommendation to do so by Greenwood’s sales agent. The court rightfully noted that South Carolina law limits a seller’s duty to disclose material facts beyond “the reach of the diligent attention, observation and judgment of the purchaser,” but in the midst of pressure from Greenwood to act quickly, it is unclear what more Russell could have done prior to making the deposit to satisfy its obligation to exercise “diligent attention, observation and judgment.”

The court noted that Russell contacted the DHEC before it made its first site visit to the plant on September 6, 1989, and DHEC indicated “that Greenwood had some violations in the past, but that the wastewater treatment facilities then met DHEC standards and that Greenwood was operating the plant within the parameters of the consent order.” While the court does not reveal the deliberations underlying its conclusion, it may have concluded that Russell’s contacting the DHEC prior to its first site visit and DHEC’s disclosure of Greenwood’s past violations supported an assumption that Russell considered the risk of environmental problems before agreeing to the $600,000 deposit. It could also be argued, however, that Russell reasonably interpreted the DHEC’s disclosure of Greenwood’s “violations in the past” and current compliance with DHEC standards to mean that Greenwood’s environmental problems were operational in nature and did not involve conditions permanently affecting the land itself.

The court’s finding that Greenwood did not have any duty to disclose its environmental problems is troubling in light of the general perception that modern law rejects the caveat emptor doctrine. Many jurisdictions, including South Carolina, still adhere, in varying degrees, to the doctrine’s basic theme — buyer beware. A buyer, operating under the false assumption that caveat emptor no longer applies, might assume incorrectly that the seller is required to disclose hidden problems, and may not realize the significant burden the buyer assumes by failing to investigate carefully and thoroughly prior to making any commitments in the transaction.

The court’s finding that information disclosing the existence of environmental defects was within Russell’s “diligent attention, observation and judgment” undercuts the efforts required by sellers to uncover such information. Buyers typically have only limited access to information. For example, absent the $600,000 good faith deposit, it is quite doubtful Russell would have been allowed the extensive access to Greenwood’s premises and records necessary for conducting a thorough environmental audit. Russell’s audit took three months, and even then its consultant could not predict with any reliable degree of accuracy the costs to eliminate the environmental defects.

In addition, the records Russell received from DHEC were obtainable only upon initiation of a Freedom of Information Act request. Certainly, such a process takes time and involves some expense. Such a search of the public records also may leave the buyer empty-handed, if the contaminated property has not yet been reported to the proper authorities. This court’s holding leaves unclear whether a public record search alone fulfills the buyer’s inspection obliga-
tion, or whether an expensive, on-site, technical investigation also is required.

Nor does the court address the increased transaction costs resulting from a buyer having to pay for the acquisition of information concerning latent environmental defects. In most instances, the seller already has knowledge and adequate information available concerning the subject. If not, surely the seller is in a better position to acquire such information than the buyer,79 because the seller typically has unlimited access to the property and is more likely to have access to information concerning the property's history.

In light of burgeoning legislative attempts to address environmental concerns, the inescapable liability a property owner often faces, and the astronomical costs typically involved in cleaning up contaminated property,78 the presence of hazardous substances always should be a significant factor in a buyer's decision to purchase real property. This court distinguishes the instant case by finding that the transaction did not involve an earnest money deposit, but an option contract. By its finding, however, the court may be sending an unintended message concerning the practicality of option contracts, at least where manufacturing sites are concerned. Option contracts are designed to give the buyer a period of time to consider its decision to buy. Such a tool is useful in the commercial world because it allows the buyer adequate time to reach an informed decision free from the fear that its efforts will be wasted.

If the discovery of undisclosed latent environmental defects during the option period does not render the contract unenforceable, however, as this court holds, it certainly impacts the value of an option. Surely Russell would not have paid $600,000 for its option if, in advance, it knew it would not get its money back when it discovered the serious latent environmental defects Greenwood knew about.

This court refused to impose upon Greenwood a duty to disclose severe latent environmental defects, even though Greenwood not only knew about the environmental defects at the time it induced Russell to put down the deposit, but also created the contamination through improper operations of its plant at the site.80 Other courts easily might have found Greenwood had a duty to disclose the defects.81 Practitioners, however, have come to expect a certain stability in the application of property law. The recent overlapping of contract, tort and environmental issues with property law has created a dangerous and perhaps unexpected unpredictability in real estate transactions.

For practitioners, even those specializing in real estate or environmental law, deciphering the current tangle of common law and statutory interpretations may prove impossible. Imposing upon sellers a uniform duty to disclose latent environmental defects would ease the current state of confusion. Nonetheless, without unanimous adoption and consistent interpretation of uniform state statutes, achieving uniformity at the state level is idealistic at best and more likely impossible.

Practitioners are therefore advised to exercise extra caution to protect their clients from unwittingly assuming liability for latent environmental defects when buying real estate. At a minimum, buyers should be advised to question sellers concerning the presence of environmental defects. A search of available public records is also prudent. Even better protection is afforded by including specific language in the contract for purchase of real estate or option permitting the buyer to rescind if environmental defects are discovered.

CONCLUSION

Neither party was egregiously injured by the court's allocation of losses between the equally skilled bargainers involved in this transaction.82 Of greater concern, however, is this holding when read in light of the current state of confusion surrounding application of the doctrine of caveat emptor and the duty to disclose latent environmental defects in real estate transactions. Until a uniform legal duty to disclose latent environmental defects is imposed on sellers, practitioners, as well as buyers, should continue to beware.

78 See Tracy, supra, note 43.
79 Long-term clean-up costs may reach $500 billion. See Tracy, supra, note 43.
80 See Appellant's Brief at 7-17.
81 See cases cited supra, note 4.
82 It is noted that both parties shared some loss; Russell lost its $600,000 deposit, plus whatever it spent on its environmental audit, and Greenwood gained $600,000 to offset its alleged $1.5 million loss from the auction.