



## The Impact on Commercial Transactions of Environmental “Stigma Damages”

In the past few years, there have been numerous references to “stigma damages” in academic and popular legal literature. In general, the term “stigma damages” refers to an amount of damages in tort that plaintiffs seek when the traditional remedy for an injury to property does not yield an amount that would make the injured party whole.

Cases in which claims for stigma damages have been made often involve an alleged reduction in the value of a parcel of property due to fear of exposure to lingering undesirable conditions. Claims for stigma damages have been raised in respect to circumstances as varied as residences infamous for past crimes, so-called haunted houses, sites located near sources of electromagnetic fields and, recently, parcels contaminated with environmental pollution. For the most part, courts have refused to grant stigma damages in the environmental context. Nevertheless, the concept of environmental stigma damages has emerged as a viable theory in at least some jurisdictions, and may yet become more widely accepted by courts nationally as plaintiffs, spurred on by a few tantalizing victories, continue to press such cases.

The following discussion is intended to inform purchasers and sellers of real property about the developing concept of environmental stigma damages, and to provide some guidance on the role of such damages in a commercial transaction.

### Environmental Stigma Damages

As a general matter, the purpose of a damage award under common law tort theory is to make the injured party whole (*i.e.*, as if the injury had not occurred). In the context of real property damage, the measure of the award traditionally has been the lesser of the cost of repairing the damage (*i.e.*, restoring the property to its pre-damage condition) and the

diminution in property value (*i.e.*, the difference between the pre-damage property value and the post-damage property value). Because both measures of damages approximate the same value (*i.e.*, the value lost to the property owner due to the damage), paying either amount to the tort claimant should make that party whole. Tort claimants generally are not awarded compensation for both repairing the property and the reduction in property value because such an award would be double recovery for the damage.

The passage of laws requiring remediation of contaminated property has compromised the utility of the traditional tort property damage formula for certain tort claimants. For instance, under certain state and federal environmental laws, the current owner of the contaminated property—the party who often cleans up historical pollution on the property—frequently seeks to recover the costs of the cleanup from other responsible parties (such as former owners) who actually caused the contamination. In recovering cleanup costs equal to those expended under the applicable environmental laws, the property owner, however, undermines its ability to also recover under the traditional damage formula for the diminution in property value allegedly caused by the contamination, since the cleanup costs are, essentially, the cost of repairing.

While these circumstances should be of little concern to a tort claimant who believes that the cost of repairing is more or less equal to the diminution of property value, claimants who believe that the diminution in property value caused by pollution is greater than the cost of remediating the pollution find the bar to “double recovery” leaves the injury less than fully compensated. These claimants argue that when the cost

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of the site remediation does not fully account for the value lost to the property owner, the injured property owner should be able to recover damages equal to the value of the remediation plus any remaining diminution in property value.

In what we call the “pure stigma claim,” this “additional” diminution in property value, the claimants argue, is due to the public’s health concerns and general fears relating to the presence or former presence of contamination on the property or nearby property. Thus, even after the contamination has been remediated, and even if the environmental agency overseeing the cleanup approved the remediation, the “stigma” of being environmentally contaminated is such that public perception causes the value of the property to remain depressed.

An increasingly relevant variant of the pure stigma claim is what we call the “residual contamination stigma claim.” Under some environmental laws, the contaminant concentration levels to which a site must be cleaned up are variable, based on many factors that correlate to human exposure to the contaminants in question. The practical result of this situation is that the applicable environmental agency may approve the cleanup of a contaminated site even though contamination is still left in the ground or the groundwater. Despite the environmental agency’s approval of the cleanup, some claimants argue that the presence of the residual contamination depresses the value of the site because of prospective purchasers’ fears of pollution.

## The Valuation Conundrum

At first glance, a claim for stigma damages may not seem problematic. If the goal is to make the injured party whole, then should not any formula that best meets that objective suffice? Unfortunately, it is not simple to determine whether a claim of stigma could be, or should be, valid.

At the heart of stigma damage theory is a debate on the nature of property valuation. The traditional property damage formula is premised on the generally accepted understanding that over time the value of damaged property will rebound fully to reflect the curing of the damage. Any failure of the value of the property to rebound in this way, according to this formulation, would reflect the failure of the remediation to cure the damage, not some subjective perception of the value of the property that finds no basis in economic theory. Contrary to this formulation, however, environmental stigma damage claimants suggest that the value of the property can

be permanently impaired by its environmental history, regardless of whether a cleanup of that property has rendered the site “clean” by the standards of an environmental agency, and that this impairment should therefore be compensable.

The most difficult aspect of a stigma damage claim is demonstrating a theoretical basis for the claim and the magnitude of the injury. In the best of all worlds, appraising the value of property is more of an art than a science. Determining the economic impact of a permanent post-remediation decrease in the value of the property that is due solely to the stigma associated with the contamination of the property is even more subjective, entailing, at least, quantifying the site-specific reduction in value due to market subjectivity, identifying the permanence of the stigma and, if permanent, factoring in changes in the value of the stigma which might occur over time.

Part of the difficulty of assessing permanent impairment to property value has to do with timing. Because the actual claim for stigma damages almost always is brought during remediation or soon after the property has been cleaned up, any market information available may well reflect a short-term decrease in property value due to the immediate past presence of the environmental contamination. And claims for temporary loss of value due to the presence of contamination, as are permitted in some states, such as New York,<sup>1</sup> while theoretically unrelated to the presence of compensable, long-term environmental stigma, presumably would be predicated on the presentation of the same type of evidence that would support a long-term stigma damages claim and would compound the evidentiary burden further.

## Court Cases

While the number of environmental claims for stigma damages has increased throughout the 1990s, few courts have recognized the claims as theoretically feasible and fewer have granted monetary damages. Today, the majority of courts that have opined on the question do not recognize or grant stigma damage claims. Indeed, the number of cases nationwide resulting in the recognition of such damages is exceedingly small, even though such damages have been pursued in many jurisdictions.

If a pattern can be discerned from the few successes and the many failures of stigma damage claims, it is that courts are generally unwilling to tamper with the traditional property damages formula. Courts have a difficult time justifying the creation of a significant exception to the traditional tort remedy, especially an exception based on a claimed injury that is difficult

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to quantify (if it exists at all) and that has little academic support. In fact, with very few exceptions, those courts that have recognized the possibility of compensable stigma damages have so recognized only in cases where the possibility of residual contamination exists, and, even in such cases, the courts have conditioned the actual damage award on nonspeculative proof of permanent diminution of property value based on the historical presence of environmental contamination.<sup>2</sup>

While courts may well refrain from recognizing stigma damages on a broader scale in the near future, arguments supporting stigma damages may continue to gain acceptance in various jurisdictions nationwide. It is possible that more and more courts will embrace an exception to the traditional tort property claim formula based on the residual contamination stigma claim. This exception would recognize that where environmentally contaminated real property has been remediated but retains residual pollution caused by another property owner, even if cleaned up pursuant to environmental law and approved by the applicable environmental agency pursuant to that law, the presence of such residual contamination, under the right set of circumstances and market conditions, may be deemed to give rise to a continuing compensable injury in tort beyond the damages represented by the cost of cleanup.

Stigma claimants will continue to pursue damages for temporary impairment of the value of the property. While not all jurisdictions currently recognize such an injury, claims related to contamination might result in the development of case law (or even statutes) supporting such claims. Damage awards for temporary loss of value due to environmental impairment may well provide courts an acceptable method of providing compensation to victims of environmental contamination without weakening the traditional property damages formula.

## Application to Purchaser/ Seller Agreements

Although stigma damages are not currently widely accepted by the courts, they have been recognized in some jurisdictions and may be recognized in additional jurisdictions as a new form of common law damages. Thus, prospective purchasers and sellers should be adequately apprised of the relevant implications.

*Purchasers.* Given the potential importance of a threat of pollution stigma to a potential purchaser's interests, particularly regarding the property's resale, it should be part of the due diligence effort to clarify whether grounds for such

a stigma may exist. In this regard, a Phase I Environmental Assessment, now routinely conducted before property transactions, can be designed to include investigation into the existence of factors that might give rise to stigma (*e.g.*, the possibility and extent of latent contamination, the likelihood of future government intervention).

If a determination is made prior to execution of a purchase contract that a threat of stigma exists, the purchaser may seek to negotiate a reduction in the property's purchase price. In arguing for such a reduction, the purchaser of a potentially stigma-affected property will have to quantify the conjectured value of the stigma involved. This probably will require hiring an appraiser.

Regardless of whether the threat of stigma is strong enough to permit a reduction in the purchase price, the purchaser should ensure that the purchase contract contains enforceable representations and a continuing indemnification concerning the presence and impact of environmental contamination on the property, such that if contamination of the property decreases the value of the property and/or gives rise to a stigma claim, the potential purchaser would be able to recover the loss. Because environmental indemnifications are already widely incorporated into real estate purchase agreements, purchasers need only ensure that the operative indemnification language covers stigma damages.

Even if the purchaser has no reasonable suspicion of stigma until after the purchase contract is executed, the purchaser may be able to "benefit" from conditions that would support a claim of stigma. Prior to closing, the purchaser may attempt to negotiate an agreement whereby the seller assumes some or all of the potential burden of such a claim if the purchase contract does not already shift it there. Unless an exclusive remedy provision prohibits such a claim, the purchaser may, of course, at any time after the contract becomes operative sue the seller for tort damages due to stigma-supporting conditions.

*Sellers.* As with prospective purchasers, prospective sellers of property located in jurisdictions where stigma damages may potentially be recognized by the courts should address the stigma issue first by obtaining adequate information about the property they are selling. Sellers can hire consultants, perhaps as part of a Phase I Environmental Assessment, to attest to the lack of stigma potential on a property by showing complete remediation or even the complete absence of any contamination to begin with. Moreover, in the event that there is the potential that environmental stigma could become an issue during negotiation of a purchase contract, sellers can hire valuation experts to come to their own independent conclusions regarding the

existence of negative market perception and the degree of market value "correction" necessary, if any. This information should minimize uncertainty regarding the potential for stigma claims associated with the environmental history of the property and help to alleviate the environmental concerns of prospective purchasers.

Generally, until the case law more uniformly recognizes stigma damages, a seller should not agree to lower a purchase price to reflect potential stigma damages threatened by a potential purchaser. Numerous studies show that any discernible stigma is transitory and that the value of impacted property returns quickly to market value.

If there is the potential for the property value to be impacted by environmental stigma, and this fact is known to both parties prior to the execution of the sale contract, the seller can validly argue that: (1) the purchase price should adequately reflect the parties' understanding of the issue and their respective risks; (2) no specific continuing indemnity in respect to the stigma issue is warranted; and (3) the sale contract should state that the purchaser assumes the risk of stigma damage liability. On the other hand, if an indemnification covering environmental stigma is to be part of the deal, the seller should assure itself that the purchase price reflects the seller's continuing liability associated with the uncertainty of any potential stigma claim, which is subject to the unpredictable and sometimes irrational and arbitrary tastes of the market.

Regardless of whether both parties recognize the potential for the property value to be impacted by environmental stigma, and especially in circumstances where the purchaser has no

such impression, the seller can argue that in the context of an "as is" contract for the transfer of real property, consequential damages should not be recoverable by the purchaser from the seller. While the concept of "consequential damages" is broad enough in most jurisdictions to include environmental stigma damages with no modification, the definition of course can be stated in the sale contract to explicitly include damages associated with environmental stigma.

## Conclusion

Though prospective purchasers and sellers of real property need not at this point dramatically alter their activities and incur significant transaction costs to guard against the cost of claims related to environmental stigma, they can make relatively inexpensive modifications in their business dealings to protect their interests in anticipation of potential future developments in specific jurisdictions.

<sup>1</sup> See, e.g., *Guzzardi v. Perry's Boats, Inc.*, 460 N.Y.S.2d 78 (App.Div. 1983); *Jenkins v. Etlinger*, 447 N.Y.S.2d 696 (1982).

<sup>2</sup> See, e.g., *In Re Paoli Railroad Yard PCB Litigation*, 911 F. Supp. 1071 (E.D. Pa. 1992) (ruling that plaintiff could proceed with claim seeking damages for "permanent, irremedial damage" and consequent diminution in value existing after remediation); *Nashua v. Norton Co.*, 45 ERC 1013 (N.D.N.Y., Apr. 15, 1997) (ruling that plaintiff could proceed with claim seeking residual diminution in value after remediation as long as "non-speculative" evidence of stigma can be provided).

This memorandum is intended only as a general discussion of the issues presented. Nothing in this document should be regarded as legal advice. Shearman & Sterling would be pleased to provide additional details about these matters or advice about specific situations. For more information on topics covered in this publication, please contact either:

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