7 deadly sins: Environmental due diligence 2.0 in a post-recession economy

What every buyer, seller, and lender should know

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Caveat emptor! How often have you ever bought a used car without first taking it out for a test drive and looking under the hood? Never? OK, good. Then why would you buy a piece of commercial real estate without doing the same thing? The answer, again, should be never. Yet far too many investors either overlook or perform shoddy pre-purchase investigations that could expose them, and their lenders, to environmental liabilities. This article provides seven common environmental due diligence "sins," or mistakes, and how buyers, sellers and lenders should protect themselves to ensure smooth, error-free and sustainable transactions.

In emerging from the doldrums that gripped the commercial real estate markets since 2008, buyers, sellers and lenders are now embarking on what has been called "Commercial Real Estate 2.0." Although the credit markets are loosening up, lenders are still very cautious about environmental issues complicating their underwriting process and subjecting them to potential liabilities as a secured creditor. With the strict, retroactive joint and several nature of environmental risks, buyers and sellers also continue to be concerned about post-closing liabilities, and who will bear those burdens.

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To address these competing and often conflicting interests, this commentary focuses on three distinct areas of environmental due diligence: legacy liabilities, operational liabilities and strategic liabilities. Simply checking the box is not enough. All aspects of a property's legacy risks must be reviewed, including past industrial activities, on-site landfills, gas stations, dry cleaners, and underground storage tanks must be identified and qualified from a historic risk perspective.

> Performing comprehensive environmental due diligence saves all parties to a real estate transaction time, money and future headaches.

Similarly, current risks from an operational perspective must be analyzed, including environmental permits, and may require an environmental audit be performed. Finally, strategic considerations, including exit strategies for investors, must be considered and factored into long-term business planning.

By taking a comprehensive and holistic view of environmental risks, from the macro, 50,000-foot strategic level, down to the micro, operational level, we can paint a complete picture of the risks for all parties involved. So don't just check the box, avoid these common mistakes and you will be happy you did.

MISTAKE 1: WAITING UNTIL THE LAST MINUTE

Effective environmental due diligence starts with enough lead time to get the necessary investigations performed to allow you the flexibility to address any issues that come up prior to closing. If the investigations are performed early enough in the transaction process, the information gathered can be used by all parties to negotiate remediation agreements, escrow hold-backs, indemnity agreements, insurance, price reductions and other deal mitigation techniques that bring more certainty to a deal.

Depending on the number of properties in a transaction, it can take several weeks to several months to conduct a comprehensive investigation. It can take weeks to wade through old environmental reports and other documents.

MISTAKE 2: RELYING ON OUTDATED INFORMATION

Hiring an experienced environmental consultant to perform updated Phase I environmental site assessments that comply with the most current ASTM International standards is an essential part of any due diligence plan. Phase I reports are deemed "stale" after one year and should always be updated no later than 180 days before the transaction.

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Commissioning updated Phase I reports allows a buyer, and by extension its lender, to satisfy the Environmental Protection Agency's "All Appropriate Inquiry" rules to qualify as a bona fide prospective purchaser and enjoy certain "innocent purchaser" protections. Failure to satisfy the AAI rules subjects the buyer and lender to Superfund liability as an owner or operator of a facility and is easily avoided with a proper due diligence protocol.

MISTAKE 3: RELYING ON UNRELIABLE INFORMATION

Similar to Mistake 2, relying on non-standard or commodity-type environmental reviews can lead to disastrous consequences. To achieve compliance under AAI rules and analogous state regulations, environmental reports must comply with the latest ASTM standard for Phase I reports (ASTM 1527-05).

In order to save on costs, some clients will simply commission a "transaction screen" or "desktop review" and simply check the box. These assessments generally consist of a simple records review and a cursory inspection of the site usually conducted by a low-level and inexperienced staff member. These types of reports are rife with potential problems and may miss key historical and operational issues that would otherwise be flagged.

The 7 deadly sins

- Waiting until the last minute
- Relying on outdated information
- Relying on unreliable information
- Failing to understand state-specific requirements
- Failing to look beyond the Phase I report
- Failure to obtain an accurate opinion of probable costs
- Overlooking mitigation tools to help manage environmental risks

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MISTAKE 4: FAILING TO UNDERSTAND STATE-SPECIFIC REQUIREMENTS

The AAI rules only address federal regulations, and, as such, a comprehensive due diligence protocol must also address state-specific analogs to the Superfund law. For example, in New Jersey certain state environmental regulations require prospective purchasers to take AAI a few steps farther in order to satisfy the innocent-purchaser defenses. This may include performing a "preliminary assessment and site investigation" that calls for a more exhaustive history of the site operations, listing of all raw materials ever stored at the site, current and past wastewater discharges (sanitary and industrial), an interpretation of the aerial photographic history of the site, and an evaluation of the protectiveness of past remedial actions.

In addition, buyers and lenders are looking more carefully at certain states that impose so-called environmental "super liens" that allow state agencies to have first position or super-priority liens against a property for which environmental funds have been expended regardless of any prior liens recorded on the property. Numerous states currently have super-lien laws in effect, including Connecticut, Hawaii, Louisiana, Maine, Massachusetts, Michigan, New Hampshire, New Jersey and Wisconsin. As such, borrowers and lenders alike must be mindful of this added layer of potential risk that could impair the value of the underlying asset.

MISTAKE 5: FAILING TO LOOK BEYOND THE PHASE I REPORT

A standard Phase I report provides useful information for evaluating recognized environmental conditions at a site, but a Phase I scope is not all encompassing. For example, in-depth investigations into building conditions such as lead paint, asbestos, PCBs, radon and mold are typically beyond the scope of a standard Phase I. Other building features that increase demolition and/or development costs include mercury and PCBs in electrical switches and lights, radioactive components of emergency-exit signs, and corroded or clogged sewer lines, which may leave openings for industrial waste to contaminate the subsurface.

Previously unknown underground storage tanks, drywells or septic systems can lie in wait until discovered during renovations. PCBs were historically used in many things besides transformers — paint, window caulking and electrical insulation among them. Dealing with all of these things costs money, and identifying as many of them as you can as far ahead of time as possible is a good idea.

In addition, a hot-button topic in recent years is vapor intrusion, which is not currently part of a standard Phase I assessment. In June 2010, ASTM issued E 2600-10, Standard Guide for Vapor Encroachment Screening on Property Involved in Real Estate Transactions, for assessing vapor intrusion issues. In the standard, ASTM defined a "vapor encroachment condition," or VEC, as the presence or likely presence of vapors from "chemicals of concern" in the subsurface of a property caused by the release of vapors on or near the property. Some commentators suggest this standard will become part of a standard Phase I report before too long.

The potential for a VEC is important from both an operational and strategic perspective. Knowing the potential need to address indoor air quality problems, including decisions regarding the need for active or passive vapor barriers and other mitigation measures, can have a significant impact on building renovations and other operational costs.

Similarly, compliance with environmental laws related to operational risks, such as the Clean Air Act and Clean Water Act, or the risk of third-party toxic-tort and property damage claims, are critical for assessing the overall environmental risks associated with any given site.

In addition, in those instances where site development is planned, environmental regulatory compliance must be reviewed. Appropriate reviews of potential wetlands,

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zoning, storm water, floodplain and sewer capacity issues may be required, along with the procurement of both state and federal environmental permits. Final development costs often are dependent on how these factors are resolved. Such factors as traffic and noise considerations may also be required in the form of an environmental impact statement. Identifying these "soft" environmental issues, and the costs associated with them, before you close can save many headaches after you close.

> Numerous states currently have "super lien" laws in effect, including Connecticut, Hawaii, Louisiana, Maine, Massachusetts, Michigan, New Hampshire, New Jersey and Wisconsin.

MISTAKE 6: FAILURE TO OBTAIN AN ACCURATE OPINION OF PROBABLE COSTS

One critical element of understanding overall environmental risk is developing an accurate representation of probable future costs. Too often environmental consultants identify potential environmental problems without quantifying the potential downside costs.

Any qualified environmental consultant should be able to provide a reasonable range of estimated costs based on a probability analysis using a best-case, mid-case and worst-case range. Buyers, sellers and lenders will then use those estimates to negotiate remediation escrows to fund the future work. Lenders will generally require from 125 percent to 150 percent of the worst-case estimate to be held in escrow to account for potential cost overruns, which inevitably occur during the course of investigation and remediation.

MISTAKE 7: OVERLOOKING MITIGATION TOOLS TO HELP MANAGE ENVIRONMENTAL RISKS

Numerous tools are available to buyers, sellers and lenders to mitigate risks associated with environmental risks identified during the due diligence process. A starting point is obtaining accurate representations and warranties from the seller as to the environmental condition of the property and compliance with environmental laws. Obtaining covenants to conduct future investigations and necessary cleanup in the form of a remediation agreement is also an essential tool to obtain certainty on the various parties' future obligations.

As mentioned above, escrow agreements are usually necessary when known investigation and remediation costs are expected. Also, where known environmental risks are identified, indemnity agreements and/or environmental liability insurance are other tools to mitigate those risks.

Lastly, certain state agencies have programs, such as dry cleaning or underground storage tank remediation funds, to assist property owners with the cost of investigation and cleanup of known contamination. These state-sponsored funds should be investigated and used, as most also provide liability protections as well.

These seven deadly sins are just the tip of the iceberg when it comes to environmental risks. Qualified environmental experts, including consultants and attorneys, who know all the intricacies of federal, state and local regulations should always be engaged when contemplating any commercial real estate transactions. Such experts will always be beneficial to buyers, sellers and lenders alike and will allow all parties to avoid the seven deadly sins of environmental due diligence. WJ

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