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ENVIRONMENTAL DUE DILIGENCE

Consider the advantages of proactive sell-side assessments.

by Dennis Papa, PE, BCEE

Phase I Environmental Site Assessments have become a well-known tool when considering environmental liability for a prospective purchase of real property. Phase I reports are usually requested by buyers or their lenders as part of due diligence for real estate transactions.

A key purpose for conducting a Phase I ESA is to qualify the purchaser for the "innocent landowner defense" provisions of the Comprehensive Environmental Response, Compensation and Liability Act, or CERCLA, of 1980. These provisions allow the buyer who performs adequate due diligence a way to avoid inheriting liability for a property's past environmental sins.

However, the findings of a Phase I ESA can make it a useful tool for the seller as well. Especially in situations where time is of the essence, performing a Phase I ESA before the property is marketed can ultimately speed up the due diligence process. The information can allow the seller to uncover contamination or compliance issues that need to be addressed prior to listing. Or, in a perfect world, a clean Phase I ESA report offered up by the seller can lessen the concern or required time when the buyer performs its own Phase I ESA.

This article explores the value of environmental due diligence to both sides of commercial real estate transactions.

Protect Your Liability

To provide a common standard that ensures a thorough Phase I ESA is being performed, the U.S. Environmental Protection Agency has endorsed the guidance developed by the American Society for Testing and Materials, an international standards organization that develops a range of technical standards, including environmental site assessments. The current ASTM Phase I standard, E1527, was finalized in 2005 and recently updated in 2013 and has largely become the industry benchmark for such investigations.

Along with liability protection, a thorough Phase I ESA also offers the advantage of educating the buyer and the seller about the environmental condition and historic uses of the property, its vicinity, and how the property may be affected by hazardous wastes and petroleum products. This helps both parties evaluate environmental risk and decide whether to investigate further, negotiate a more favorable transaction, or walk away.

Additional factors such as business environmental risk, defined by ASTM E1527 as "a risk which can have a material environmental or environmentally-driven impact on the business associated with the current or planned use of a parcel of commercial real estate," also should be considered. While these are often left outside the scope of a Phase I ESA, environmental issues such as suspect asbestos-containing building materials, lead-based paint, radon, mold, historic resources, floodplains, and ecological resources including wetlands and endangered species can have a material effect on the property and business.

Should We Let Sleeping Contamination Lie?

Of course, by proactively pursuing environmental due diligence, an owner runs the risk of discovering contamination on the property, being required to fund additional investigation and cleanup, and possibly having to respond to further requirements from regulators.

But a savvy buyer will consider this very same potential when doing its own due diligence. In the heat of the moment prior to a final purchase agreement, the buyer will often adopt a worst-case scenario and assume that a potentially contaminated property could fall into a lengthy regulatory process and require an aggressive cleanup to background levels or the most stringent standards applied by the particular state or local agencies.

Alternatively, if initiated well in advance of sales negotiations, the seller can have time to gather Phase I results and perform a follow-up investigation, such as a Phase II ESA, if needed to define the nature and extent, and more important, future actions, for environmental liabilities. If some regulatory response or cleanup action is required, the seller can work with the regulators to obtain its formal approval, such as a certificate of satisfactory completion or "closure letter" prior to marketing the property.

Closure letters are often the gold standard when considering ways to limit future liability, as they offer the blessing of the local regulators and usually carry some reciprocal protections from federal regulators and courts as well. Deed restrictions on use, such as limiting residential development or use of groundwater for drinking, can be legally implemented by the seller before listing the property. If the seller waits for these issues to be brought up during the due diligence period, even the addition of simple deed

language or restrictive covenants could take too long to be legally implemented and often will lead to delays in closing.

In cases where commercial and industrial properties go through the closure process, the regulators will apply the often less stringent "commercial/industrial" standards. While still designed to be protective of human health and the environment, the commercial and industrial cleanup standards are generally less expensive to implement since the protections take into account the controlled access and limited exposure at industrial sites. Similar controls for parks, schools, residential developments, and other public access properties are generally more restrictive and expensive.

A proactive closure process also can head off a prospective purchaser who, in the absence of having a formal closure letter, may insist on assuming the more-stringent closure options and therefore negotiate an accordingly greater price concession to offset this scenario, even when it may not apply to the particular property use.

Case Studies

The benefit of sell-side Phase I due diligence prior to listing a property was evident in a recent transaction involving a New England-based industrial manufacturing property with several tenant operations. One of the tenants stored waste materials that caused at least a perceived risk of contamination to soils and groundwater on the property. The seller engaged an environmental consultant to perform a Phase I ESA, who then recommended a Phase II ESA to conduct soil and groundwater sampling at strategic locations on the property. The Phase I ESA revealed no other recognized environmental conditions or concerns at the property.

The property owner had allowed himself enough time to perform the due diligence in hopes of resolving any issues prior to deal making. A potential buyer came along earlier than expected and was able to review the existing environmental reports. The buyer still elected to do its own Phase I ESA to satisfy lender liability and obtain CERCLA protection. But when it came time to consider potential for contaminated soils, the buyer's consultant was able to simply review the seller's Phase II data, which the buyer relied on to base an offer. The seller's proactive environmental due diligence allowed him to be ready for the unexpected early sale, which saved more than a month of due diligence time.

Another example of proactive sell-side environmental due diligence occurred during the sale of a manufacturing warehouse located in Indiana. The property had received multiple environmental impacts from past operations that released contaminants to site soils and groundwater in excess of state standards, some of which were still undergoing monitoring and cleanup.

While environmental practices had greatly improved over the years, the property owner realized that the existing contamination created a legacy that most prospective purchasers would be reluctant to inherit. When it came time to sell, the owner provided detailed Phase II investigation and sampling results and partnered with the state Department of Environmental Management to produce an environmental restrictive covenant that provided environmental controls and liability limitations.

The prospective purchaser's Phase I effort not only considered the standard items, but could focus on available data and the ERC and how these may impact new owners' future business operations and liability. The effort that would have been spent on exhaustive and intrusive investigation was instead diverted toward producing a solid sales agreement that led to closing and saved money and time.

Knowledge is power. By acting proactively, property owners with suspected environmental issues can use the information gained through environmental assessments to move sales transactions forward in a timely manner.

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ENVIRONMENTAL SITE ASSESSMENT ELEMENTS

A Phase I ESA evaluates current and past activities and Recognized Environmental Conditions on and adjacent to property:

+ Review existing reports
+ Consider past uses to 1940 or first development
+ Conduct user interviews and questionnaire
+ Search chain of title and lien
+ Review historical maps and photos
+ Review compliance records
+ Identify regulated sites within appropriate search radius
+ Conduct thorough site inspection
+ Review business environmental risk factors
+ Update report within 180 days of purchase date
+ Certified by environmental professional

A Phase II ESA includes the following:

+ Sample soil, groundwater, surface water, sediment, soil vapor, building materials as needed
+ Assess risk
+ Consider need and scope for regulatory response and remedial action

— Dennis Papa, PE, BCEE