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*Advisory Series*

Environmental  
Due Diligence –  
9 Steps  
Companies  
Should Take to  
Effectively Manage  
Environmental  
Risks in  
Commercial Real  
Estate Deals

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Buyers and sellers in commercial real estate markets understand that property and portfolio acquisition deals can carry financial and legal risks. Environmental concerns, particularly those undiscovered during a property acquisition, present additional and sometimes costly risks. The penalties of acquiring an environmentally impaired site can have tremendous financial, legal, and reputational implications for companies that acquire contaminated property. That is why it is imperative that buyers/investors utilize regulatory-compliant and comprehensive environmental due diligence procedures to effectively evaluate environmental exposure in commercial real estate transactions.

## The key is to identify potential environmental risks early in the acquisition due diligence process.

It can be challenging to understand how certain environmental risks can impact commercial real estate deals. Some risks can have major consequences and may increase the chances of acquiring property with substantial environmental liabilities or cause the transaction to fail. These risks can have long-term negative impacts for a company that acquires environmentally-impaired properties. For example, groundwater contaminated with chlorinated hydrocarbons can cost millions of dollars and years to clean-up and monitor. It can also potentially impact indoor air quality (IAQ), exposing employees/tenants/occupants to contaminants in the groundwater via vapor intrusion into the site improvements. Using regulatory compliant and comprehensive environmental due diligence tools at the outset of the overall due diligence process is a cost effective strategy of manage environmental risks.

### **Tools for the Assessment of Environmental Risks: The Phase I Environmental Site Assessment**

A Phase I Environmental Site Assessment (Phase I ESA) is used to identify potential or existing environmental risks/liabilities related to commercial real estate properties. The passage of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) has underscored the importance of performing environmental due diligence for each and every commercial real estate transaction. Under CERCLA, a property owner of a site from which there is a release or threatened release of hazardous substances, regardless of fault, can be held liable, simply by virtue of

ownership. In 2005, the United States Environmental Protection Agency (USEPA) established specific regulatory requirements and standards for conducting all appropriate inquiries (AAI) into the previous ownership and uses of a property for the purposes of qualifying for certain landowner liability protections under CERCLA. The Phase I ESA is the tool for satisfying AAI requirements set forth in 40 Code of Federal Regulations [CFR] Part 312. All Phase I ESAs must be performed using the Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process (E1527-13). The current version of this standard was revised in 2013 and is compliant with AAI requirements and standards. Not using the American Society for Testing and Materials (ASTM) standard to assess commercial property or using consultants that do not meet the definition of an environmental professional (EP), as defined in the AAI regulation, may eliminate the possibility of qualifying for the innocent landowner defense under CERCLA.

Environmental risk adds complexity to the due diligence process, particularly when soil and/or groundwater contamination is known or suspected. Environmental risks can potentially reduce the market value of property; increase property insurance premiums and the self-insured retentions associated with environmental coverage; and/or exclude coverage of known contamination; subject owners to costly remediation (CERCLA liability); and expose owners to third-party law suits from abutting property owners and current or future tenants. Environmental risks that are anticipated to occur in the



## 9 Steps Companies Should Take to Effectively Manage Environmental Risks in Commercial Real Estate Deals

future are referred to as contingent environmental liabilities. For publicly traded companies, actual and contingent environmental liabilities must be disclosed in financial statements. Companies with significant environmental liabilities on their balance sheets carry reputational and operational risks if these liabilities are not addressed at their facilities.

*To ensure that due diligence provides a comprehensive evaluation of potential environmental risks, companies contemplating the acquisition of commercial property should consider the following nine steps as part of the due diligence process:*

### **1. Ensure your consultants use industry standards and best practices to assess environmental risk (ASTM E1527-13 standard to conduct Phase I ESAs).**

Environmental assessments must be performed in accordance with AAI requirements to qualify as an innocent landowner, as defined by CERCLA. Consultants providing this service should clearly state the standard and assessment methodology in their proposal for the Phase I ESA.

### **2. Include environmental experts on your due diligence team from the start.**

A thorough environmental risk evaluation requires experts who understand the target industry and its environmental exposures as well as the jurisdiction where the property is located, applicable state and local environmental regulations, and appropriate risk assessment methods. Consultants must meet the definition of an EP, as defined by the AAI regulation.

### **3. Retain consultants with working knowledge of area-specific environmental issues.**

Decades ago oil and gas exploration was common in the city of Los Angeles. The presence of former and active oil fields has caused subsurface methane



to build-up in certain areas of the city. Methane gas is flammable and when present in high concentrations, can become an explosion hazard, especially within enclosed structures. The city of Los Angeles Department of Building and Safety developed a “Methane Zones Map” showing areas of the city where methane gas may be present at hazardous concentrations in the subsurface. Acquiring property in a methane zone requires methane testing or methane mitigation. Buyers of properties in the city need to be made aware of the possibility of acquiring real estate in a methane zone. Consultants with the knowledge of local environmental concerns would be able to direct their clients to avoid acquiring property potentially impacted by methane gas.

### **4. Physically inspect the property.**

In addition to researching available government and historical records of the site, it is critical to walk the property. The site visit should include discussions with current owner/tenants, neighbors in surrounding areas adjacent the property, and local officials to identify existing or past environmental issues, and other potential risks not documented in historical records. Equally as important, but not required by the ASTM Standard, are the identification and testing of other potentially hazardous or regulated

materials such as asbestos, lead paint, contaminants in drinking water, and mold. These environmental issues if not identified in the Phase I ESA, present risks for property development and renovation, and potential risks to employees and tenants if not addressed.

### **5. Assess the current regulatory compliance status of the property.**

This includes a review of existing permits (i.e., Air Emissions Discharge, Stormwater, and Industrial Waste Discharge Permits) held by the current facility operator as well as evaluating compliance status with applicable hazardous waste management regulations. All waste streams and designated disposal facilities need to be identified.

### **6. Identify applicable regulatory guidelines used as thresholds of contamination.**

Typically, states have established human health-based standards to screen soil, soil vapor, and groundwater for contamination. It is important that consultants are familiar with established standards in the areas they provide service. Typically, consultants performing site assessment work in the same geographic area are familiar with applicable health-based standards to screen soil, soil vapor, and groundwater for contamination.

### **7. Assess environmental risks and set thresholds.**

Once environmental liabilities become known, additional site assessment and remediation costs can be estimated. A company should decide how much it is willing to invest to assess known environmental risks and how much post-acquisition risk it is willing to retain. These thresholds may also be dependent on requirements set by the lenders or investors involved with financing the property acquisition.

### **8. Seek indemnity agreements with the sellers.**

Where potential environmental liabilities exist, companies should seek to negotiate with the sellers to include indemnities or liability transfers where necessary or appropriate. The buyer should confirm the financial stability of the entity providing the indemnity, or risk being responsible for future remediation costs

### **9. Transfer environmental risks by using Environmental Liability Transfers (ELTs).**

Corporate holders of environmental liabilities can mitigate risks through a transaction commonly referred to as an ELT. ELTs are used to remove environmental liabilities from the pending transaction while providing both the buyer and seller with corporate indemnifications from and against all future environmental liabilities.

Many properties have some level of inherent environmental risk. To avoid potentially expensive and unanticipated liabilities, environmental concerns should be placed on an equal footing with financial and legal implications during the due diligence process. By thoroughly evaluating the environmental liabilities in a transaction, companies can be more confident that an acquisition will provide opportunities for growth, rather than unanticipated liabilities for costly environmental remediation.

As previously mentioned, acquiring an environmentally impaired site can have tremendous financial, legal, and reputational implications for companies. Organizations can incorporate the nine steps above into their corporate due diligence policy and when utilized properly, can be a valuable risk management tool to manage environmental risks related to real estate transactions.

#### **About the Author**

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