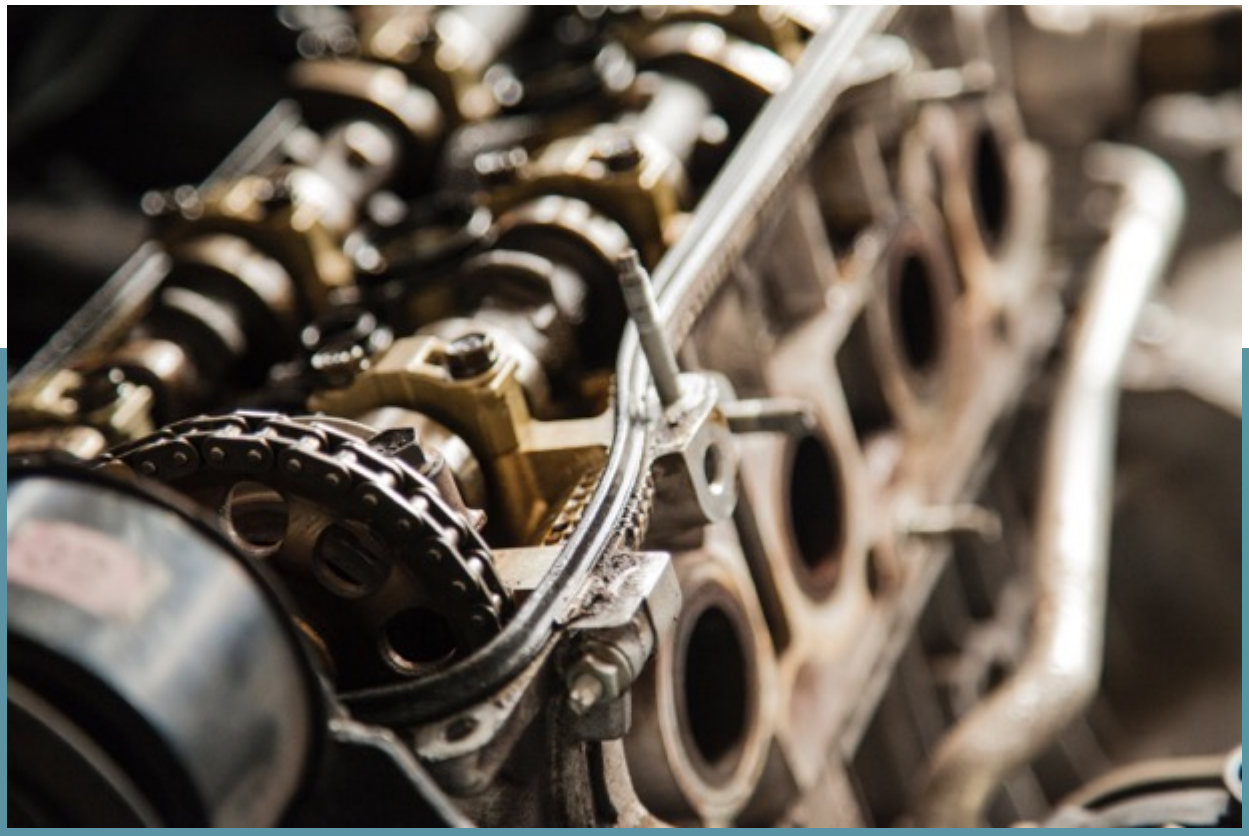
Environmental Due Diligence, Don't Buy That Car Before You've Looked Under the Hood

By Kathy Lehnus, PG, LEP, Farallon Consulting

If someone were to offer you a 2022 Tesla with low miles for $5,000, would you buy it? Sure! But before you handed over the cash, you would probably look the car over and test drive it. But are you doing everything you can to make sure you aren't getting a lemon? Maybe you would also take it to your mechanic to run a diagnostic. And maybe you would ask for estimates on what would need to be replaced in the near future. You might even look for a mechanic with lots of Tesla experience who knows what is likely to break and what it will cost to repair. If not, you may have just purchased more problems than you're prepared to deal with.



Environmental due diligence is to real estate what assessing a used car is to making sure you will enjoy that car for years to come. History is replete with examples of individuals and corporations buying properties and then having to pay millions (and even lots more) to take care of environmental issues that could have easily been identified, and planned for, at the front end. Once you own a property, even if you never caused any issues, you are likely going to be held responsible for conducting any cleanup needed on or downgradient from the property. This millstone of responsibility can even fall to the banker, investor, or insurer who is fiscally responsible for one of these investments.

One of the few ways around that crippling responsibility is to establish yourself as an "innocent landowner" where you show you performed "all appropriate inquiries" into the property before acquiring it. It's for that reason that bankers and other savvy lenders require all appropriate inquiry before investing money. To help with the all appropriate inquiry qualification, the American Society for Testing and Materials (ASTM) devised guidelines for the preparation of Phase I Environmental Site Assessments (ESAs), which provide a federally-recognized procedure for technical professionals to identify environmental concerns so they can determine risk during their transactions. These guidelines, with their updates, are the gold standard of what the industry uses today to understand environmental risk. But the Phase I ESA is the baseline assessment (e.g., your used car test drive); there are many more tools to add to your toolbox that can help you open the hood, turn the wrench, and understand what you are buying.

Let's dive into why environmental due diligence is important. When boiled down to its core, due diligence can be defined as "the care taken to avoid harm." The environmental due diligence industry has been developed to provide stakeholders like lenders, insurers, regulators, purchasers, and sellers with a clear picture of the environmental liabilities for the property or business transaction. This helps them avoid harmful and costly issues that can be discovered later, like investigation and remediation, delays in development schedules, lawsuits, regulatory fines, and bad publicity. Environmental due diligence evaluations are intended to discover and, if desired, evaluate liabilities for a variety of properties and transactions, including purchase, sale, or leasing of real property or businesses. These evaluations can extend far beyond Phase I ESAs, and include Phase II and III subsurface investigations focusing on the potential for on- and off-site impacts, with assessment of the extent of impacts. And when contamination is found that needs to be addressed, you can ask for rough order of magnitude cost estimates to help you address the liabilities discovered during the Phase I ESA and fleshed out further with the subsurface investigation in the Phase II and III processes.

And yet there are still those transactions that are closed without evaluation, because stakeholders decide against evaluation due to factors like a benign property use considered unlikely to have caused issues, a future planned industrial use with perceived “lower risk” receptors, a lack of change in site conditions since the last evaluation, or simply as a means to save money. Stakeholders may feel that there likely aren’t any environmental problems, or problems of any significance, that would be discovered during an evaluation. But the savvy investor knows that there could be unforeseen conditions and additional information discovered that might change opinions. Or the opinions of the environmental professional could change based on changing regulations, rendering previous conclusions obsolete. Certain environmental indemnifications, like the innocent landowner defense, have no possibility of being invoked without documentation of a proper environmental due diligence process. In other words, reliance on previous reporting may prove problematic, not only from a legal reliance capacity, but also because the decision maker must take into account the age of the work, changing regulations and availability of information, and even the purpose of the user for whom the previous report was prepared. On the latter point, the environmental professional may have provided conclusions in the report that were based on the original user’s redevelopment scenario of industrial rather than the newly-planned, and higher risk, residential scenario.

And for those seasoned bankers, brokers, and developers who are savvy to the importance of environmental due diligence, it is worth accentuating that there are differing levels of assessment, contingencies, and risk tolerance that must be taken into account when using the resulting data to understand environmental liability in the decision making process. Understanding the tools used to conduct environmental due diligence evaluation and their limitations is paramount to understanding the extent of environmental risk. A Phase I ESA is the ground level of any good environmental site assessment process and can be used to develop a conceptual site model detailing the potential for release locations, types, volumes/durations, and migration pathways. But a Phase I ESA has over 1,000 pieces of information that can be gathered from dozens of sources. If there are time limitations due to market pressures, the user should build extra contingencies into the findings that account for the potential that key issues may have been missed and later records or new interviews may be uncovered that document those issues. In a similar manner, if moving forward with subsurface investigation as part of the due diligence process, the number of samples, analyses, and ability to digest the data with an appropriate understanding of the presence and/or extent of releases needs to be considered when time or budget constraints have been administered. That being said, the user can use appropriate expert input to understand the limitations of the assessment and determine what contingency should be set when relying on the data in order to formulate estimated costs and timeframes associated with environmental liability with rough order of magnitude remedial cost estimates. This is the car-buying equivalent of relying on your trusted and experienced Tesla mechanic.

The preparation of rough order of magnitude remedial cost estimates would be the final step of a robust environmental due diligence process. These are estimates prepared to address known potential environmental liabilities based on the previous assessments, and must account for the limitations used to determine those liabilities, including things like age of the assessment, limitations of the assessment, and current (and applicable) regulatory criteria. In the right environment, rough order of magnitude remedial cost estimates can also address the potential for future environmental liabilities that have not yet been discovered. In order to be useful, the estimates must incorporate current regulatory standards with regard to cleanup goals, including sensitivities around vapor intrusion risk, and also must seek to incorporate some level of future regulation expectations, including off-site assessment and long-term monitoring. This level of effort is largely based on the opinion of the environmental professional who prepares the evaluation and is well outside of the ASTM guidelines to complete Phase I ESAs. The work should include an open discussion between the user and the environmental professional to understand future uses, goals, the potential for regulatory involvement, and risk associated with the planned use of the estimates.

In summary, just as it is wise have your expert mechanic inspect that used car you are about to buy, a robust environmental due diligence process can be your lifeline to inform you of and/or potentially release you from being on the hook for time-consuming and expensive remedies. The end result of a truly robust and successful environmental due diligence process must incorporate an understanding of the elements and reliability of the assessment, the process for completion, and the limitations of the work. This process can go well beyond the simple guidelines of a Phase I ESA completed for high-risk properties that has become the baseline standard evaluation, and will involve collaborative conversations with experienced environmental professionals who understand liability related to many different environmental histories, risks, and transaction types. The savvy investor goes into decisions with eyes wide open, knowing what they are getting into (and what it will take to get out of it) rather than risking buying a lemon.

Kathy Lehnus, PG, LEP has over 28 years of experience managing projects in the environmental consulting industry, helping clients understand the risks associated with the purchase and redevelopment of contaminated or potentially contaminated properties. Kathy's areas of expertise include due diligence, investigation/remediation work plans, and regulatory navigation; and support to stakeholders to help them understand liabilities associated with investigated properties.