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Due Diligence: Avoiding Risk, Protecting Your Investments

By Bruce Nickelsen and Jim Okun

Cleanup costs, if not detected early enough, can exceed the value of a property. Environmental due diligence is a necessary risk management tool to assure the value of the underlying property, and avoid possible costly environmental cleanup. Here are some basic points of information when determining your commercial property's risk factors.

The heart of a well-planned environmental due diligence effort is the ESA, standard for environmental site assessment. When competently executed, the ESA is likely to identify significant latent conditions. In most cases, an ESA based on historical research is adequate to assess risk. However, when past use of petroleum or hazardous materials is suspected at the property, environmental testing of soil and groundwater is usually recommended.

The following are important reasons for conducting environmental due diligence. Some of these speak specifically to the Commonwealth of Massachusetts program requirements, but most Northeast states have comparable regulatory programs for:

- Qualifying under the federal Comprehensive Environmental Response, Compensation and Liability Act or CERCLA, that protects property owners (and banks should they become an owner through foreclosure) from the cost of performing Superfund level cleanups provided carefully executed due diligence has been performed;
- Avoiding Massachusetts Chapter 21E liability. This statute allows the state to: perform property cleanups when responsible

parties do not; recover up to three times the actual cleanup cost from responsible parties; and replace a lender's primary lien with the state's claim for reimbursement (the notorious "super-lien" provision);

- Avoiding the loss of capital liquidity as cleanups progress and are possibly delayed while waiting for government approvals and contractor performance;

Avoiding potential law suits from the owners of adjacent properties injured by contamination on a property; and

- Qualifying for potential brownfield grant money under appropriate circumstances.

The New Site Assessment Standard

The rules for environmental due diligence are now changing and the changes are driven by a term called All Appropriate Inquiry or AAI. This is a story that began 20-plus years ago and is just now coming to full fruition.

When the U.S. Congress passed the Superfund Amendment Reauthorization Act (SARA) in 1985, it introduced a concept called "The Innocent Landowner Defense." This provision granted property purchasers protection from potential Superfund liability provided they completed AAI prior to closing on a purchase.

SARA did not provide specificity as to what AAI should include. To address this gap, the American Society for Testing and Materials published the first AAI standard in 1993. The standard is known as the Phase I Environmental Site Assessment Standard (E 1527-93; updated in 2000 to E 1527-00). Their standard experienced broad acceptance by the real estate lending community and has been in regular use since its initial publication.

Then in 2002, Congress passed the Brownfields Amendments to CERCLA, which required the Environmental Protection Agency to establish specific stan-

dards for conducting AAI. The Agency published the final rule on Nov. 1, 2005, and the rule will be completely phased in on Nov. 1, 2006. After that date only the new standard (E 1527-05) carries CERCLA benefits.

Key AAI Provisions

Sorting out the various factors in the new AAI standard will take some time, but it will inevitably be a central part of the environmental due diligence landscape.

The new rule incorporates more quality assurance features, such as requiring that AAI be performed by an "environmental professional." This is defined as a person possessing certain combinations of education and relevant work experience. Lenders will want to verify the credentials of their ESA vendors. One solution is to have AAI performed by state licensed environmental professionals, such as licensed site professionals in Massachusetts and licensed environmental professionals in Connecticut. The use of a state licensed environmental professional ensures an increased level of technical competency.

The rule also incorporates key elements of the previous standard including: a site reconnaissance; records review; interviews; and documentation of recognized environmental conditions. However, the new rule extends the scope of certain due diligence activities and requires specific documentation of data gaps.

Interviewing the current owner is now required under the new standard compared to the "reasonable effort" to interview as previously required. Past owners and occupants should also be interviewed. For vacant properties, interviews with neighboring property owners are needed. New data sources, such as possible tribal records and the presence of institutional or engineering controls must be assessed. Users of the Phase I assessments are required to consid-

Continued on Next Page

BRUCE NICKELSEN is an associate at O'Reilly, Talbot and Okun Assoc. Inc. (www.oto-env.com). He is responsible for the environmental site assessment program in their Westborough office. JIM OKUN is a principal at OTO with company-wide ESA responsibilities.

Continued from Previous Page

er reasons for a significantly lower purchase price, in situations where a property is being transferred.

Their Own Set of Challenges

The combination of soaring residential property values and increasing concerns about environmental quality by prospective purchasers has led to a greater demand for environmental due diligence prior to residential property transfers. With choice residential homes often valued well above the

cost of commercial properties, buyers want to know that they will not need to incur future costs for environmental remediation, inside or out.

The number one concern for residential properties is the presence of fuel oil tanks. Many people are aware of the risks from underground tanks. However, we see more and more problems caused by above ground tanks, particularly where the lines leading to or from the tank run under or through a concrete basement wall or slab. These lines are out of sight and can deteriorate over

time due to variety of causes. A leak in a line is often as serious as a leak directly from a tank. Our expectation is that environmental due diligence for residential properties will grow as time goes on.

The scope of environmental risks has expanded in both commercial and residential real estate. But, by conducting a thorough risk analysis, collecting data, defining the problem and developing a solution that is compliant, the diligent property owner will minimize the risk and maximize the profit from their investment. ■

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