

# Why Due Diligence is Necessary

Strong environmental assessments make for strong deals

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**T**ODAY'S LENDERS ARE SCRUTINIZING every aspect of a deal to make sure it is a good one. Environmental due diligence on commercial real estate deals is more important than ever.

Brokers who are armed with the knowledge of basic environmental due diligence can determine whether a property will make a good deal — or a bad one — for their clients and lending partners.

## The importance of due diligence

Due diligence — the process of getting as much information as possible about a transaction before closing — is a proven way to avoid bad deals and litigation. When it comes to commercial real estate, one of the most-common issues that impairs — or even kills — deals is environmental contamination. For this reason, lenders routinely require some sort of pre-purchase environmental screen.

Depending on the goals and the terms of the deal, lenders can use one or more of the following screening tools to check for contamination:

■ **Phase I environmental site assessment:** Prepared by an environmental professional, a Phase I assessment includes a review of available records for the subject property and its surrounding area, a review of historical records, a site visit, and interviews with past and present owners, operators and occupants. The final report contains documentation of all records reviewed, observations made during the site visit, results of the interviews, an explanation of any gaps in data and any recognized environmental conditions uncovered. It also includes conclusions and recommendations.

■ **Transaction-screen assessment:** Prepared by an environmental professional or bank officer, the transaction-screen assessment consists of a

questionnaire for property-owners or occupants, a site visit to observe property conditions and a limited environmental-records review.

■ **Desktop review:** Environmental-data companies compile, map and continually update millions of federal, state, local and tribal environmental records culled from public databases. Lenders can order and retrieve reports, which help identify environmental concerns on the target property and its surrounding area for any U.S. location. Historical information is also available.

■ **Environmental questionnaire:** The property questionnaire is a basic document that contains anywhere from 10 to 25 questions designed to

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determine if a property has any environmental conditions. The lender typically submits this document to the borrower or seller for completion. As a result, this environmental-screening tool represents the no-cost approach to environmental due diligence, but it lacks outside verification. For this reason, the questionnaire's usefulness is limited.

Regardless of the method used, conducting thorough environmental due diligence early in the deal gives brokers and their lenders an advantage. By learning about potential problems upfront, they have time to address any issues before closing.

Tighter due-diligence practices allow all parties in the deal to understand the extent and potential costs related to the exposure in a timely manner. If problems arise, deal terms can be restructured, if necessary.

## Common mistakes

“Buyer beware” has a significant meaning in the real estate industry. But sometimes environmental due diligence is dismissed, done shoddily or rushed through at the last minute. Even if time and money are tight, some form of environmental due diligence can be done. Quick, cost-effective screens can be performed right from a desktop computer.

Common blunders when evaluating environmental issues include:

**1. Going with a low-cost Phase I site-assessment-provider:** When a full-scale Phase I environmental site assessment is in the cards, many choose an environmental firm based on price. Going with

the cheapest provider has the obvious advantage of cost savings, but it may result in a shoddy job. In the past few years, there has been a trend toward the commoditization of Phase I assessment: There are mills producing inadequate reports for a minimal fee. Quick-and-dirty screens can lead to crucial missed information, and saving a few-hundred bucks doesn't look so good when facing thousands of dollars in cleanup costs. If the deal calls for a Phase I assessment, make sure to hire an environmental professional who is qualified to conduct assessments under the U.S. Environmental Protection Agency's All Appropriate Inquiry (AAI) rule and who is experienced in assessing properties for recognized environmental conditions and other risks.

**2. Rushing the report:** Although they can sometimes be prepared more quickly, Phase I assessments generally require three to four weeks to complete. Before they prepare the report, environmental professionals not only must visit the site but also must talk to past owners, operators and the like. They also should request information about the site from various governmental bodies, which takes time. Demanding a faster turnaround

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may compromise the environmental consultant's ability to obtain information, which leads to data gaps. Gaps in data can compromise the quality of the assessment; furthermore, they must be accounted for and explained. The sooner you order the Phase I, the better. Everyone is facing schedule pressures, especially in the wake of the credit crunch. But tighter underwriting standards are the norm, too. Plan for at least a couple of weeks to give your environmental professional enough time to request and receive site information.

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**3. Relying on old reports or making assumptions about the deal:** Never assume that a deal is free from environmental problems and that a Phase I is simply a formality. No one knows where the assessment will lead until all the facts are in. And don't rely on outdated, inaccurate or incomplete reports. Industry standards assign a one-year shelf life from the date of property purchase for the environmental inquiry, with a 180-day shelf life for certain components. Make sure your report is current. Changes in site conditions since the report was prepared could significantly alter the property's environmental contamination status.

**4. Ignoring the past:** Environmental professionals who are called upon to review work of their peers most often cite poor historical reviews as the most common problem they encounter. For the purpose of determining environmental risk, a site's history is just as important as its current use. A doughnut shop may look innocuous, but it could have big environmental problems if it used to be a dry cleaners.

**5. Believing a Phase I environmental site assessment is all-inclusive:** Designed to help the user avoid liability under the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), a Phase I is not a catch-all screen of every environmental issue that could affect a property. Those issues outside the scope of a Phase I include things such as mold, asbestos, lead paint and

vapor intrusion. An environmental professional can help determine whether taking on additional assessments is prudent.

### Bottom line

Commercial real estate volume is down significantly, but deals are still getting done. While brokers and their lenders may face greater challenges than usual, there are plenty of prudent practices they can employ to make good deals while they wait for the economy to improve.

Skimping on due diligence, while perhaps an attractive short-term option, is myopic. Because environmental issues are complex and often hidden, a detailed environmental desktop report — or a thorough inspection by a qualified environmental professional when the deal requires it — is a prudent practice. It should be considered for every commercial real estate deal. **!**

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