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Due Diligence on Due Diligence

Richard C. Woroniecki
Cornell University

Jean L. Woroniecki
Cornell University

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Abstract

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Unfortunately, to most real estate professionals, the grasp of environmental issues still lands somewhere between a necessary evil and the dreaded environmental financial black hole. Industry frustration is split between understanding the “standard” and the varying level of consultants’ performance. Our goal in this article is to help the real estate professional do due diligence on his or her due diligence process to provide a better understanding of what you need for a specific transaction. This includes understanding the update and the various environmental screening tools available as well as understanding the differences in environmental consulting firms and consultants. This article will not make you an expert, but it will hopefully help you better evaluate screening options and select expertise when picking your due diligence team.

Keywords

Cornell, real estate, Environmental Site Assessments, ESA, Compensation and Liability Act, Phase I, American Society for Testing and Materials, ASTM, Scope of Work, contractors, consultant, qualifications, risk, requirements, insurance policy, closing, professional, negotiation

Due Diligence on Due Diligence

By Richard C. “Ric” Woroniecki and Jean L. Woroniecki

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Concerns regarding the vast differences in the quality, depth and reliability of Phase I Environmental Site Assessments performed by consultants have resulted in modifications to the American Society for Testing and Materials (ASTM) Standard Practice for Phase I Environmental Site Assessments (ESAs). The new “standard,” ASTM E1527-05, was finalized to dovetail with 2002 changes in the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) that took effect in 2006. Many do not understand that neither the new, nor the old “standards” were designed to address all environmental concerns. The 2005 upgrade has resulted in two basic options for Phase I ESAs: one to meet the “standard” and one with a broader scope that better addresses “environmental business risk.” Even with all the changes, industry frustration remains high since many clients don’t understand the needs and the differences. This article’s original intent was to explain the recent changes, but in development it quickly became obvious a review of the entire process was in order.

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What Is a Phase I ESA and Where Did It Come From?

If you ask real estate professionals what a Phase I ESA is, more often than not you get an answer indicating that it is a broad, in-depth review of all environmental issues that might affect a subject piece of real estate, as well as a guarantee against environmental problems backed by the consultant’s insurance. But, if you ask a qualified environmental consultant the very same question, he will respond that it’s a very *limited*, preliminary screen for select environmental issues, and there is no guarantee regarding the site conditions; the only guarantee is that the consultant did his investigation similar to the way others would do it at the same time, in the same place and under the same conditions. Unfortunately for the real estate professional, if you read the consultant’s proposal, the contract for the work and his insurance policy, the consultant’s position is probably correct and you will have very little or no coverage regarding site issues if problems arise if the written scope of the Phase I ESA is contrary to your needs.

There are broader and/or different scope ESAs that cover many different issues, so terminology is important as in any area of risk management. The “Phase I” ESA is a limited screen of the property in an attempt to identify limited, select items of environmental concern known as *recognized environmental conditions* as defined by ASTM (and hence, loosely by CERCLA). In general,

author

Richard C. “Ric” Woroniecki, the *Environmental Minesweeper*, graduated from Cornell in 1978 with a Chemical Engineering degree. During his 30-year career in environmental consulting he has risen to the top ranks and ownership of significant environmental engineering and consulting firms. He provides environmental screening, consultant oversight and project management to real estate development and management firms as well as lending institutions, as well as lecturing and teaching environmental issues to industry and at several universities including Cornell and the Georgia Institute of Technology.
Woroniecki@bellsouth.net



CERCLA covers releases and potential releases of chemicals and petroleum: storage, current or past releases and spills, above-ground and underground tanks and similar environmental concerns. The general scope was developed in an effort to provide *all appropriate inquiry* as defined in CERCLA. Oversimplified, CERCLA is environmental legislation that holds a property owner responsible for very expensive environmental cleanups and other damages, whether that owner caused the contamination or not. CERCLA specifically defines which environmental situations are covered, and it is a limited list which does not cover all environmental issues. For example, it does not cover asbestos, lead-based paint, mold and indoor air quality, lead in drinking water, wetlands/water resources and ecological considerations, nor operations requirements (i.e., permits). More on out-of-scope issues later.

Performing *all appropriate inquiry* is a key element in establishing the *innocent landowner defense* provided under CERCLA. Successfully establishing the *innocent landowner defense* means that you may not have to do the expensive cleanup or be held responsible for additional damages resulting from contamination on your property if you did not cause, add to, or disturb the problem. The underlying principle is that if you adequately tried to investigate for possible contamination before you bought the property and you didn't find any or dealt with what you found, you are therefore an "innocent landowner" regarding hidden contamination and the government will not compel you to deal with the issues under CERCLA. Hence, the goal of the Phase I ESA is to avoid future cleanup costs and liability on select limited issues. It is not an all-encompassing guarantee that there are no environmental problems of any kind, nor any hedge against plummeting property value if a problem is discovered later.

When lawyers and consultants first started interpreting CERCLA and the resulting rules and regulations, the environmental assessments performed and the consultants' qualifications varied widely, to say the least. There was little specification regarding licensing, education or experience for those performing the work under CERCLA. ASTM stepped in and established a "standard" for performing Phase I ESAs that has become the most common guideline in the industry. As knowledge grew and concerns became apparent, the ASTM "standard" was updated several times (identifiable by the title ASTM E1527-xx, where xx is the year of update). The 2002 Brownfield amendments to CERCLA enhanced the *all appropriate inquiry* definitions and requirements and better defined the qualifications necessary to perform the work. This led to highly publicized revisions in the ASTM "standard" resulting in ASTM E1527-05, which was widely published and reviewed prior to the final CERCLA rulemaking, which took effect on November 1, 2006.

It is important to note that ASTM is not a government agency; it is an industry trade group. Therefore, the ASTM "standard" was historically only a *guideline*, not rule or law. This has changed to a degree: Since the latest revision (ASTM E1527-05) is referenced specifically in the revised CERCLA regulations, the 2005 version carries the clout of law.

Legislative and ASTM Guidance Changes

As stated earlier, CERCLA narrowly defines which environmental situations are covered, resulting in a limited list that is not inclusive of all environmental issues. As opposed to altering the extent or nature of the environmental areas of concern covered, the new ASTM instead changes the way the investigation is conducted to uncover possible issues. The new guidance calls for several things specifically:

- Mandatory interviews with past and present owners and/or a *significant* attempt to do so
- Review of historical property information, with a clearer definition of what is acceptable
- Review of tribal and local government records, not just state and federal
- Visual inspections of the subject and adjoining properties by professionals with *seasoned* expertise and adequate technical training
- A better search for commonly known or reasonably ascertainable knowledge

author

Jean L. Woroniecki (Ric's daughter) graduated from in 2005 from Cornell's Hotel School with concentrations in Real Estate and Law. She interned with a hospitality real estate valuation and assessment consulting operation and her initial post-graduation employment was with a start-up CMBS unit at a major lending institution. She was subsequently recruited to a major New York-based global investment bank, where she works in the Real Estate Program in the Fixed Income Division (CMBS unit). Jean.woroniecki@gmail.com.



Scope of Work

Experienced consultants and real estate owners may not feel this snapshot looks much different from the earlier version, but a review of the definitions of these items reveals that they are in fact substantially enhanced requirements. One of the bigger changes is the mandate to document gaps in the data and provide a professional opinion on possible environmental concerns. In the past you only had to *try* to get data; if it were not available, there could be broad gaps in documentation but still a seemingly favorable outcome stating that “based on available data, no concerns were identified.” Obviously, significant gaps can be a concern in and of themselves, depending on the nature of ownership and operations. Under the new guidelines there is a heightened requirement to identify and evaluate the quality of the data and comment on it, not simply review what is actually found.

Another possible concern with data review remains: In the past, while many sources of data might be readily available, the guidance only required review of a limited amount of data—typically two sources—not all reasonably ascertainable data available. This has been improved in the new guidance, but use of all available data is still not specified. We are not suggesting an exhaustive, expensive search; a review of readily available data is recommended. A minor downside is that a search for, and review of, all reasonably ascertainable data usually is more expensive, since it takes more time. Still, large clients and proactive real estate professionals are frequently willing to pay for and require a review of available sources, while smaller players or less savvy operators might unknowingly still take the minimalist approach, even to the detriment of their own exposure.

The requirement for interviews is now similarly enhanced. In the past, virtually any feeble attempt to interview the property owner or his representatives was considered adequate to meet the guideline. If striving for the innocent landowner defense was the goal, some would take a head-in-the-sand approach not wanting to know about issues, since “knowledge” could lead to liability and responsibility. Now, there is a more stringent requirement to interview the owner, his representatives and neighbors. If the operation on the property was one that could possibly have caused CERCLA issues, an interview with the owner generally needs to be followed up with interviews with his engineers and other technical experts. Accurate documentation of interviews with the owner and owner’s representatives is also critical, considering the owner’s responsibilities to divulge certain negative information in many states. Interviews with neighboring property owners are now sometimes specified, not just a drive-by “windshield review” of the adjoining sites as was past practice. The current intent is a *quest* for actual information, not simply a feigned attempt to establish the defense.

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New Requirements for the Purchasing Real Estate Professional

In addition to the enhanced specifications for the Phase I ESAs, there is an enhanced responsibility of the real estate professional requesting the work, and while it doesn’t enter into the Phase I ESA report, it is required to establish the *innocent landowner defense*. The prospective purchaser must now do the search for environmental liens, financial assessments or set-asides (as financial security against property environmental concerns) that may be the responsibility of the current and future property owners. He also has to conduct an economic review of the purchase price versus the unimpaired fair market value and analyze if there may be a price reduction due to environmental concerns. Now, the purchaser has the enhanced requirement to seek out and assess commonly known or reasonably ascertainable information. In layman’s terms, what this means is that the client can no longer say “I didn’t suspect” when he buys significantly discounted property. Further, he is obligated to proactively seek information and conduct research as opposed to requesting that no one tell him anything of concern so he won’t have “knowledge,” where in the past lack of knowledge was an escape mechanism for environmental clean-up liability. Environmental consultants rarely have the expertise to perform a title search and most real estate professionals might not recognize potential environmental problems in a

chain of title review. Hence, while the onus is on the purchaser, the search is best done by an experienced environmental attorney and reviewed with the environmental consultant. Such out-of-scope services may be above the Phase I ESA costs.

Consultants' Qualifications and Performance

As you might imagine, investigating the issues targeted by the Phase I ESA is highly technical work. One can only assume it was intended to be performed by seasoned scientists, engineers and geologists; however, little regarding licensing, education or experience was specified under CERCLA or in the early guidance. Chemicals and petroleum are stored in and pumped between tanks, vessels, drums and other storage containers, which are usually under the purview of engineers. Once released, how and where the chemicals migrate and what damage results is typically the domain of geologists, chemists, biologists and other scientists. Frequently, the issues require commingling of these capabilities and expertise.

Scientists, engineers and geologists have all stepped up to the need. However, with little guidance in the form of qualifications and a swelling market for these services, those with questionable credentials could call themselves "environmental consultants" without concern or sanction, since there was no mechanism for performance evaluation or sanction against substandard work. The consultants weren't regulated, only the property owners. The "consultants" could be anyone familiar with tanks, drums and spills, meaning construction workers, excavation contractors, and the mechanically inclined. Many with no formal education on the issues or technology, and only marginally related experience, became "experts" in the field. This confusion was exacerbated by self-serving trade groups forming and issuing meaningless certificates and registries. Certification in many cases simply entailed paying a small fee, without no or minimal educational, technical or experience requirements. While this segment is relatively small, it is responsible for the lion's share of service problems and client complaints.

The concerns in selecting a consultant to achieve a desired result do not entirely rest with the unqualified consultants in the marketplace. The majority of consultants are well-educated and trained in their areas of expertise. However, just like lawyers, there are many different areas of environmental practice. Fundamental concepts are transferable, but expertise is channeled. You wouldn't hire a divorce attorney to defend you in a murder case. Similarly, using an asbestos expert or firm to do a Phase I ESA is risky. Even when using a firm or individual qualified to do Phase I ESAs, options regarding discovered *recognized environmental conditions* may be beyond their expertise.

Obligations of the Real Estate Professional

The final concern with consultants actually rests with the real estate client. The science and experience of environmental consulting is not a commodity service, and all consultants are not created equal. After the adoption of CERCLA and the ASTM guidance, services became better-defined and cost of the services dropped. In turn, as the economic pressure on consultants trying to turn a profit increased, consultants turned to hiring less expensive, younger and perhaps less-qualified staff. Many consultants targeted the *minimum* scope necessary to meet such guidance and protect *their* liability, rather than focusing first and foremost on the *client's* liability. Expanding on basic scopes to meet the client's goals declined as work was awarded strictly by low price. Beware contracting for ESAs, a complex risk management product, by soliciting blind low bids, without considering consultants' specific qualifications. Qualified consultants and real estate professionals alike know you can't get adequate risk management services in such a fashion, much less the best protection possible. Bargain-basement pricing, and the limited amount of service and care that come with it, undermines the qualified consultants' ability to perform adequate services at a reasonable price.

The situation was exacerbated by a flood of legal actions in two divergent categories: the first, upset clients who lost a deal or faced increased obligations when non-CERCLA issues were

identified in a report; and second, at the other end of the spectrum, clients who faced liability when minimalist scopes were employed and environmental concerns surfaced after the work was performed and the property was already purchased. In the early days, when clients sometimes did not have the time or inclination to learn about environmental issues and liability, they frequently forced the consultant to be their “expert” blindly, unknowingly forcing them to work without sufficient guidance on the goals of the environmental assessment. Caught in the middle, consultants gravitated to minimal, well-defined scopes of work based on the ASTM guidance in their proposals and contracts. While this better protected the consultants from legal action, when facing a “low bid” situation, it diminishes the consultants’ ability to provide comprehensive services and expertise and hence the best risk evaluation for the client.

New Requirements for Consultants’ Qualifications

In earlier versions, the ASTM guidance left broad gaps of interpretation as to the consultants’ qualification requirements. To close some of the gaps and address the issues described above, the latest revision has tightened up the guidelines with respect to both the scope of work defining issues and the consultants’ qualifications requirements. Specifically, the ASTM guidance now assesses qualifications in several ways:

- Government issued certification or license plus three years experience
- A four-year degree in *related* science or *related* engineering plus five years experience
- Professional Engineer’s license
- Professional Geologists license
- Equivalent of 10 years related experience

Unfortunately, the last item was allowed to “grandfather” some of those in the business who did not meet the education and licensing requirements. So, while the situation is improved, educationally marginal or unqualified “consultants” can still practice. Let the buyer beware!

Regulation and qualification of consultants remains a weak area. There are no Phase I ESA police. “Regulation” is only present in the form of increased liability on those who practice without proper credentials. However, they will only be penalized once they are sued by a client, after the damage is already done. Shall we discuss the possibilities of cost recovery from the low bidder in such circumstances?

All too often, the relationship between the real estate professional and the environmental consultant is adversarial, or tense at best. The best results will come from developing long term relationships and partnering with various environmental experts that you and your firm have pre-qualified for certain select areas of expertise.

Environmental Business Risk Beyond CERCLA

Environmental investigation and support services existed long before CERCLA and the ASTM guidance. Before the guideline was incorporated into regulation, both real estate professionals and consultants frequently morphed the environmental assessments as necessary into a product more directed at evaluating “environmental business risk” rather than focusing on the innocent landowner defense. Since 2006, when the updated laws and regulations regarding *all appropriate inquiry* and the innocent landowner defense took effect and incorporated ASTM E1527-05, two primary versions of the Phase I ESA have emerged. The first, the topic of this article to this point, is designed in an effort to assist in establishing the innocent landowner defense. The second is targeted at screening for “environmental business risk,” and includes a review of CERCLA issues but is expanded as necessary to include asbestos, lead-based paint, mold and indoor air quality, lead in drinking water, wetlands/water resources and ecological considerations, operations

requirements (i.e., permits), and so on. In any given deal, a custom scope of work is developed based on the type and history of the property and the client's goals. While it is possible to devise a scope to cover all issues and also provide for the innocent landowner defense, in most cases, this would be overkill and would incur needless additional expense.

Finally, while this article is focused on environmental issues which are typically driven by law and regulation, the popularity of Property Condition Assessments (PCAs) is also on the rise as an integral part of the due diligence process with savvy investors and lenders. A PCA is simply a "home inspection on steroids" used for commercial properties. It evaluates HVAC, paving, roofing, electrical systems, plumbing, building envelope, and so on, and provides estimated budgets to bring deficiencies back to normal operating condition.

Selecting a Team and Moving Forward

The client's final consideration is when to engage the environmental consulting team. Historically, the Phase I ESA is requested after the real estate purchase decisions have all been made and a legal and real estate team has conducted financial and market feasibility studies. Only when the property looks like a good buy and contracts are signed, which is typically after considerable expense, is the environmental evaluation commissioned, usually on a very short timeline and at minimal expense. All too often, problems are discovered that can cause headaches or worse, kill the deal. Waiting until the last minute can prove to be a penny wise but pound foolish approach.

A better approach would be to include a senior environmental consultant in your management team from the outset. I'm not suggesting a protracted, expensive relationship, but getting a "grey haired, long in the tooth" professional in at the conceptual stage can generate long-term benefits. He will be able to quickly point out possible environmental pitfalls in the process and assist in scheduling and budgeting for their evaluation. This kind of proactive approach frequently saves everyone's time and expense. The additional benefit is that manageable environmental concerns can be smoothly integrated into the project instead of being rude discoveries late in the game, requiring emergency treatment and expense to meet a closing deadline. In general, the sooner you know about environmental concerns, the easier it is to make them part of the purchase and pricing negotiation. Effective team management can keep the seller's problems from becoming your problems.

Whether using an environmental guru or simply engaging a reputable firm for the ESA, you should insist contractually on immediate verbal communication of possible concerns when discovered. The consultant should contact you verbally a minimum of three times before the final written report: first, after the "file review" (the search of historical records); second, after the site visit; and finally, several days before the report is due and/or the closing. Day-of-closing surprises should incur consequences for the consultant, as enumerated in the contract. Of course, a responsibility also rests with the real estate professional in that they must provide for an adequate schedule, allowing three weeks minimum or even more for a complex site. Fieldwork should never predate the file review as examining possible issues identified in the file review is a critical part of the field exercise. The consultant's proposal should reference the 2005 ASTM guideline and highlight any additions and/or deletions from the scope, as well as deviations from the qualifications requirements for both field and senior staff. Many consultants state that they follow the guideline, but peer reviews indicate there are many deviations. When evaluating consultants, have them demonstrate they meet the ASTM standard with a copy as a checklist in their hand.

Addressing Identified Issues

As concerns are identified, the appropriate expertise can be retained to evaluate and resolve the problems. By having a managing environmental partner, sub-consultants and subcontractors can be brought on at reasonable negotiated rates for specific scopes rather than the emergency

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response that occurs so frequently just before closing. Also, don't jump too quickly to accept "no further action" (NFA) letters or environmental insurance policies as an acceptable resolution to past issues. NFA letters and insurance policies are usually written with a very narrow focus and many preclude future disturbance. If you buy a site with an NFA or insurance policy and alter site conditions, you most likely have bought into the responsibility for residual environmental issues. An NFA status for an industrial site redeveloped as lofts may not only void the NFA terms, but saddle the property owner with significant liability up to and including criminal charges if tenants are hurt or become sick. Evaluating such issues will usually require the expertise of both the environmental professional and a seasoned environmental attorney. Routine "closing attorneys" and attorneys who practice civil law may be at a loss on complex environmental issues.

There is another value in requiring verbal updates from your consultant, namely, the avoidance of creating a paper trail. It may be desirable to avoid emails and written communication on possible concern items at early stages of the evaluation, since some issues (such as asbestos or mold remediation) can be resolved by the seller before closing, legitimately avoiding additional disclosures and expense. On the other hand, you should exercise great caution before pressing consultants to rewrite language for reports. Discuss your concerns and desires, but then let the environmental professional produce the technical opinion. If he's a team member, he will work with you as best he can, but his professional opinion is what ultimately protects your liability, not the written word or the insurance policy. Such client-driven alterations are all too common a practice. Some clients may believe they are shifting liability to the consultant or his insurance company when in fact the opposite may be true: If the consultant provides an opinion of conditions and the client insists on altering that position, the client is usually held liable if issues arise down the road.

Even with this process, when work is complete you may wish to get a first draft of the final report and have it reviewed by another consultant. It may seem like common sense, but be sure that all drafts are labeled clearly as such, so that if and when changes are made, such changes are easily defensible. This is not appropriate for every project and of course it costs more and takes more time. However, when complex issues are identified, usually greater liabilities are present and a more proactive approach to due diligence may be money well spent.

The result of the above recommendations is a complete, valuable document that identifies not only the issues, but also the proposed resolutions. The various parties can agree to financial responsibilities in advance, and financing and closing flow much more easily.

Closing Thoughts

Finally, let us also advise that you read and understand the documents produced (not just the executive summary)! It is easy to become complacent and file away a skimmed report that may flag serious issues. Make sure you review and discuss issues with the consultant to make sure you know the extent of the issue and the options for dealing with it. Also, realize that not dealing with identified issues simply because you think the risk is manageable can torpedo the innocent landowner defense. The basis for that defense is that you did not discover issues *or you dealt with what was found*. It is not grounded in a decision on your part that risks were within an acceptable range, it's based on establishing no concerns of any type were present when you purchased the property. This is another area where legal expertise is critical if the innocent landowner defense is your goal.

We highly recommend you consult with a qualified *environmental* attorney regarding these options and environmental issues that may affect your project. In today's environmental minefield, what knowledge you have and when you gained such knowledge can affect your responsibilities and liabilities even if you don't buy the property. An integrated team of legal expertise, real estate savvy, comprehensive environmental capabilities, and building/construction systems expertise should be involved from concept to closing and beyond in every transaction.

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