Defining environmental due diligence in CRE - by Chuck Merrit

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The phrase “due diligence” applies to everyday aspects of life. Many times, in ways we may not ever realize. Looking at the weather for the day impacts the clothes we put on (due diligence). More meaningful decisions like buying a company and needing to understand all aspects of that company require more due diligence. However, with environmental issues and buying commercial real estate, sometimes the definition of due diligence gets skewered. Over the years, I have spoken with clients interested in buying commercial real estate who make statements like; “I really like the property so, the phase one environmental report needs to come back clean” or “I just need something to make my lender happy.” This is not due diligence as it is more of a hopeful outcome without going through the process.

With every new version of the American Standard of Testing Materials (ASTM) E-1527 environmental standard, (currently using the 21 version released in February of 2024) the onus on the buyer and consultant increases. Consultants are expected to be more cautious when advising their clients and purchasers are expected to heed such warnings, known as Recognized Environmental Conditions (REC’s). Many times, there may be an existing phase one report prepared several years ago during a previous transaction. However, if that report was prepared for a seller (who may have been the buyer when the report was prepared) or for a lender, it will not meet the definition of due diligence today. Having a relationship (and contract) with a consultant you trust to look at the property with a fresh set of eyes is important. It will also ensure you meet the Threshold for Comprehensive Emergency Response Liability Act (CERCLA) law. There are legal protections that a lawyer practicing in this area can better explain.

I have also encountered buyers that have a 1031 Exchange situation where they have a limited amount of time to find another property to offset the taxes on a property they recently sold. I have been involved in scenarios where they identify a new property with only a few weeks left to close. In many instances they do not leave enough time for environmental due diligence (beyond the phase one) which will take more time to complete. Buyers tend to assume the phase one will be okay without any real understanding of current or past operations at a particular piece of property. Or purchasers wait too long to order a phase one report as they negotiate other aspects of the deal with the seller. They end up losing time allocated in the contract which allows for environmental due diligence.

As an environmental consultant, more data is always better than less data. Yes, it will cost more to drill some holes on a property or to test the soil/groundwater. Yes, it will cost more to sample for harmful vapors below a structure and the air quality in a building, but the downside of missing these red flags can be disastrous. The most recent ASTM Standard requires a greater look at adjacent properties in the same manner you would look at the target property. So now the former drycleaner or former gasoline station, a few doors away may trigger a recommendation for additional testing. This extra step will be valuable as it will provide more data about the property being purchased and help give comfort to a lender considering the loan. The lending entity may want to hire an outside firm to review the environmental reports you bring to them. Lenders are more aware of these concerns as they utilize internal and external experts to advise them. In addition, obtaining more data now will be valuable to provide a future buyer (or lender) that you conducted extra due diligence during your acquisition.

In July of 2024, the Federal Environmental Protection Agency (EPA) added two chemicals to the hazardous substance list. Per- and polyfluoroalkyl substances (PFAS), and perfluorooctanesulfonic acid (PFOS). These forever chemicals, and hundreds more, are used in almost every aspect of our daily lives. Originally used as a waterproofing agent and manufactured by several large chemical companies in the United States, these chemicals are now in our soil and groundwater (not to mention our bodies) and do not break down, thus the phrase “forever chemicals”. I encourage anyone reading this article to watch the movie “Dark Waters” as it provides a historical timeline of these chemicals and how they were introduced into society (spoiler alert — you will never look at Teflon the same way) and the health risk they pose to us all. Understanding if these chemicals are present and how they impact buying commercial real estate or obtaining a loan on commercial real estate has become very challenging.

These seismic shifts in 2024 are increasing awareness and the need for additional investigation in many transactions. From new ASTM standards to the EPA adding two forever chemicals, to lender awareness of these concerns, buyers need to afford consultants the proper amount of time (and money). Looking for the cheapest provider to fast track the process and hoping for a certain outcome verses understanding the environmental aspects of the commercial real estate being purchased can lead to costly mistakes and a piece of property that may not be able to obtain financing.

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