
ADVANCE DUE-DILIGENCE ACTIVITIES BENEFIT CONTAMINATED REAL ESTATE TRANSACTIONS

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Brownfields have been defined by the Environmental Protection Agency as: abandoned, idled or underused industrial and commercial facilities where expansion or redevelopment is complicated by real or perceived environmental contamination.¹ The number of brownfields in the United States has been estimated to be between 400,000 and 600,000 sites.²

Investing in, owning, developing, or making a loan on contaminated real estate entails risks which can be difficult to quantify and evaluate. Much of the excess risk facing brownfield investors and lenders stems from federal and state statutes and rules. Federal legislation passed in 1980 known as the Comprehensive Environmental Compensation and Liability Act (CERCLA), also called the "superfund" law, cast a broad net which covered many potentially "responsible parties" for brownfields related liability.³

The CERCLA legislation has had some unfortunate and unintended consequences. Fear of becoming a "responsible party", under CERCLA, has caused investors and developers to ignore brownfield sites and build in outlying "greenfield" locations causing sprawl, decentralization of employment and reduction of property tax base. Some owners of contaminated property tried to avoid the "strict liability" doctrine of CERCLA by hiding information and not publicly reporting environmental financial exposures in their financial statements.⁴ Lenders have resisted financing brownfield projects fearing that they may eventually become owners through foreclosure. In addition, some municipalities have refused to take possession of tax delinquent contaminated prop-

erties because of the potential environmental liabilities. The fear of becoming a potentially "responsible party" under CERCLA has precluded many attempts to remediate, redevelop, or to sell brownfield sites.

The many uncertainties involved in selling contaminated real estate often make the transactions expensive, lengthy, and at high risk of not being completed. Uncertainties such as: the cost of environmental due-diligence, the cost of cleanup, the likelihood of obtaining approvals of closure from regulatory agencies, and the risk of acquiring or retaining the environmental legal liability often make selling a brownfield site a low percentage real estate transaction. Sellers of contaminated real estate often become discouraged as buyers are reluctant to make offers to purchase due to the potentially high cost of environmental investigation, cleanup, and other risks. In addition, lengthy time delays resulting from false starts and a series of failed transactions add to the frustration and cost of selling contaminated real estate.

Beginning in the 1990s, a new focus on combating urban sprawl and a backlash against perceived unrealistic cleanup standards encouraged federal and state regulators to remove some of the impediments to brownfield redevelopment. The effort included: lender and buyer liability reform, widespread adoption of "risk-based" cleanup standards, and new approaches to site closure. At the same time, technical advances in site investigation and remediation technology, and the maturation of the environmental engineering market, have helped reduce or moderate the costs of environmental due-diligence and cleanup. Environmental insurance companies responded to regulatory reform and moderating remediation costs by creating several new insurance products to manage and transfer environmental risks.

The recent changes in brownfield regulation, technology, and environmental liability insurance have ameliorated risk and uncertainty and created new opportunities to sell properties that would have been unsalable in the past. However, access to these brownfield tools, whether regulatory, technical, or financial, requires an understanding of site conditions that few sellers obtain prior to their entry into the marketplace. As a result, sellers experience a greater risk of offers failing to close and of higher transaction costs.

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PURPOSE

This article illustrates the benefits, from the seller's perspective, of performing some of the critical due-diligence activities prior to, and in preparation for, marketing real estate. The sellers advance due-diligence will be shown to be a prudent and reasonable method of overcoming buyers reluctance to submit offers to purchase as well as providing the seller with a more solid basis upon which to value the property, quantify the environmental risk and evaluate the offers which are made. Through the use of advance due-diligence, it will be argued and illustrated that sellers may be better able to evaluate and select the "best" offer and reduce time delays and transactional costs.

METHODOLOGY

A transactional review will be made of a recent sale of a manufacturing Brownfield site located in a medium-sized midwestern city. The seller was a company involved in federal bankruptcy proceedings and was highly motivated to make a timely sale at a price and terms that were acceptable to the creditors committee. Since time was of the essence, and local investors were aware of perceived environmental problems at the site, the seller decided to perform many of the due-diligence activities in advance of soliciting offers to purchase.

The effect of performing sellers advance due-diligence will be evaluated and reviewed within the context of the eight offers to purchase which were

received on the property. All of the eight offers were drafted by attorneys skilled in real estate environmental law and were received during the submittal periods established by the bankruptcy court. By tabulating the important issues of the offers to purchase, it will be possible to see how, from the seller's perspective, the advance due-diligence expedited the evaluation and negotiation of the offers, and ultimately the closing of the transaction.

THE BROWNFIELD PROPERTY

The subject property is located close to the downtown business district in a rapidly growing Midwestern city. The site borders an area of light manufacturing, utility, and industrial service businesses and is surrounded by a transitional residential neighborhood.

To prepare the property for sale, the owners commissioned Phase 1, Phase 2, and Supplemental Phase 2 environmental site assessments (ESAs). Phase 1 ESAs are generally the starting point in the environmental due-diligence process. A principal goal of a Phase 1 report is to identify if past environmental management practices have created the presence of Recognized Environmental Conditions (RECs). RECs refer to the presence or likely presence of hazardous substances or petroleum under conditions that might indicate a release into the ground, groundwater or surface water.⁵ For many sites with long histories of commercial or industrial use, RECs are commonly identified, and follow-up investigation is needed to determine if the potential releases have actually occurred. At the subject property, RECs were found. They included: potential soil and groundwater contamination from underground petroleum storage tanks, historical use of solvents, and releases at nearby properties.

Based on the phase 1 results, the seller elected to perform a Phase 2 investigation to assess concerns identified by the Phase 1 report. The Phase 2 investigation included more detailed reviews of environmental files for several off-site releases on neighboring properties to learn if they might be contaminating the seller's property. Several RECs on the subject property were also investigated. In particular, a magnetometer survey was performed on areas where underground storage tanks were suspected and 10 borings were made to collect soil and groundwater samples near the current and suspected historic underground tanks and a bordering rail corridor.

To prepare the property for sale and remove as much uncertainty as possible, three underground tanks were removed and some contaminated soil from each tank basin was excavated. The Phase 2 report concluded that limited soil contamination remained at one former tank location, and that shallow groundwater was contaminated in excess of state standards at two former tank locations. The groundwater impacts were thought not to have migrated off the property. In addition, an area with solvent contamination was identified, but the source was thought to be coming from off-site.

The Phase 2 report concluded that two areas could be submitted to state regulatory authorities for closure, and one area was likely eligible for reimbursement under a state fund that pays for cleanup of releases from petroleum tanks. However, additional borings and four groundwater monitoring wells were recommended to identify the extent of soil and groundwater contamination. Without the additional data, it would be difficult to present closure requests to regulators or remediation cost estimates to potential buyers and environmental liability insurance underwriters.

The seller agreed with the consultant's recommendations for additional site investigation to remove or reduce uncertainty regarding remediation costs and to get regulatory approval to close as many areas on the site as possible. In addition, the consultant was asked to perform supplementary historical research to identify the possible location of two fuel oil tanks identified in an older report and potentially still present on the site.

During Supplemental Phase 2 work, four groundwater wells were installed and six borings were done. The sampling results showed that the previously identified groundwater solvent contamination was coming from off-site. With this information, the property owner applied to regulators for an exemption to liability for that issue. Regulators also closed two tank areas, under the condition that residual soil impacts not fully removed be identified on the property deed. Another historic tank area, which was installed under a thick concrete floor in an interior space, was shown by borings to have contaminated soil and groundwater that exceeded standards. Because of its location, a decision was made not to attempt remediation, and a request for closure was submitted with the understanding that a notice of the contamination might have to be placed on the property deed. Finally, lead was detected in soil, which was under

Exhibit 1

Summary of Price and Terms of Offers to Purchase Made on Subject Property

Price	Pays for Future Testing Prior to Close	Pays for Remediation Costs	Responsible For Obtaining Case Closure	Environmental Liability After Closing	Seller Escrow for Remediation Costs	Action Taken
Offer 1 \$6.0 million	Seller	Seller	Seller	Seller- capped	150% of estimated costs	Rejected
Offer 2 \$4.25 million	If required, seller pays	Seller	Buyer	Seller	150% of estimated costs	Accepted Closed
Offer 3 \$4.0 million	Seller	Buyer	Buyer	Buyer	150% of estimated costs	Accepted Failed on Zoning Variance
Offer 4 \$2.61 million	Buyer	Seller	Seller	Buyer	150% of estimated costs	Rejected
Offer 5 \$2.16 million	Seller	Buyer	Seller	Seller	No	Rejected
Offer 6 \$2.0 million	Buyer	Seller	Seller	Buyer	No	Rejected
Offer 7 \$1.9 million	Buyer	Buyer	Seller	Buyer	No	Rejected
Offer 8 \$1.0 million	Buyer	Buyer	Buyer	Buyer	No	Rejected

industrial standards but over residential standards, and some low levels of volatile organic compounds (VOCs) in groundwater were attributed to nearby abandoned tanks.

In summary, the seller undertook Phase 1 and Phase 2 due-diligence to remove as much uncertainty as possible prior to the sale. Actual remediation was limited to tank removals, some minor excavation, and monitoring to demonstrate that residual contamination had not spread off-site. The seller took advantage of "flexible closure" options by leaving low concentrations of contaminated soil and groundwater in place at the "cost" of several deed restrictions which future buyers were certain to discover in their search of title. To further reduce uncertainty, the seller undertook additional historical reviews of two unconfirmed underground tanks.

MARKETING AND SELLERS DUE-DILIGENCE

When a seller markets contaminated real estate without first completing environmental due-diligence, a common sequence of events is: seller negotiates listing contract with broker, broker markets property, buyer writes offer to purchase with contingencies and due-diligence conditions so that relevant information about the property and the contamination can be gathered and evaluated by the buyer, offer(s) to purchase is negotiated to an accepted offer, buyer performs and pays for environmental due-diligence reports (i.e. Phase 1 and if necessary Phase 2 environmental studies). The potential outcomes of the transaction are:

- a.) Buyer removes contingencies and due-diligence conditions and transaction closes
- b.) Buyer and seller re-negotiate contract terms and price based on due-diligence results
- c.) Buyer requests additional time for further testing or evaluation or to obtain approvals or closure from regulatory agencies
- d.) Buyer fails to remove contingencies and due-diligence conditions and contract fails

From the seller's perspective, this process contains four inherent flaws. First, the prospective purchasers are reluctant to write offers since they have little or no information about the type or extent of the contamination on the site. The buyers may waste time and expend large sums of money investigating the environmental aspects of a property in a transaction which ultimately does not close.

Without adequate information, sellers can waste time and money negotiating with buyers whose proposed use is incompatible with environmental conditions existing at the site.

Experienced buyers recognize this threat and typically reduce offer prices to reflect potentially excessive due-diligence costs, or attempt to share or transfer costs to sellers. Second, the seller lacks important information necessary to quantify the cost of remediating the contamination or the diminished value of the property as a result of the existence of contamination. Without this critical information, it is difficult or impossible for sellers to negotiate from an informed position, or to select the most appropriate offer. Third, costly time delays and re-opening of contract price negotiations are built into a system which has a buyer pricing a property and entering into future expensive due-diligence with very little information available at the time of writing the offer. Finally, under flexible and risk based closure regulations, some site uses, for example residential housing, may be prohibited or conditionally limited if residual contamination exceeds threshold limits. Without adequate information, sellers can waste time and money negotiating with buyers whose proposed use is incompatible with environmental conditions existing at the site.

EVALUATING OFFERS TO PURCHASE ON THE SUBJECT PROPERTY

During the submittal period, the marketing efforts of the seller's real estate broker produced eight offers to purchase which ranged from a low of \$1 million to a high of \$6 million with the mean offer being \$3.1 million. (See Table 1.) The Brownfield transaction reviewed in this article was characterized by high offer to purchase variability, partly because of differences in buyer's use values and risk tolerances, but primarily because appraisals done for the buyers produced highly inconsistent estimates of market values.

The appraisal done for the seller included a review of the phase 1 and phase 2 studies, and the seller's appraiser consulted with the environmental engineers who performed the studies and understood the nature of the contamination present. The sell-

er's environmental engineers had estimated the costs to remediate the contamination, and the seller's appraisal was for \$4.1 million.

Table 1 displays the key elements of each of the eight offers to purchase. The highest offer to purchase of \$6 million was based on an M.A.I. (Member of Appraisal Institute) appraisal, which did not review or take into consideration the Phase 1 or Phase 2 environmental audits. The offer was rejected since it was contingent on obtaining federal and state grants within eighteen months of the acceptance of offer. The take as is, no contingency, no due-diligence offer of \$1 million was rejected for being too low, as were the \$1.9, \$2.0, \$2.16, and \$2.61 million dollar offers.

Most of the lower offers provided that the buyer would:

- 1.) Pay for additional testing
- 2.) Pay remediation costs to obtain case closure
- 3.) Assume all environmental liability
- 4.) Not require any seller escrows

By having the advance due-diligence information, the seller was able to objectively diminish the value of these perceived benefits and reject the offers. Without the information, the seller would not have had a solid basis for quantifying or estimating the value of the above variables.

After reviewing the environmental studies, the seller felt that having the buyer pay for remediation costs and be responsible for closure was worth the \$250,000 differential between the \$4.0 million offer and the \$4.25 million offer. Since the seller was in bankruptcy, the liability after closing became a moot issue. Although offer number three (of \$4.0million) was accepted, the buyer was unable to obtain necessary zoning changes, and the offer died for failure to remove the zoning contingency.

Offer number two, which had been accepted in a secondary position, became primary and all contingencies were removed. The sellers advance due-diligence documents, which were reviewed by the purchaser of offer number two prior to writing the offer to purchase, were turned over to the buyer's environmental engineer for final review. No further environmental due-diligence beyond what the seller had performed was necessary. The transaction closed 3 months after the offer to purchase was made.

CONCLUSION

The conveyance of contaminated real estate is an extremely difficult and complicated transaction. The common approach of putting a property on the market for sale and waiting for offers to purchase, which typically contain lengthy due-diligence provisions, increases the risk that the transaction will ultimately fail. Buyers need quality information about the nature and extent of the contamination in order to be able to make informed offers. Sellers, buyers, and appraisers require a solid base of environmental information to be able to objectively quantify the diminished value of the property that results from the existence of real or perceived environmental problems.

From the seller's perspective, having the important environmental information in advance of marketing the property will assist in the evaluation process as the appraiser and/or broker can be counseled by the seller's environmental engineers. By going into the transactions with a solid basis from which to make decisions, there is less opportunity for costly time delays, reopening contract negotiations, and unnecessary or redundant environmental investigations.

By working together prior to marketing a brown-field property, the appraiser, the environmental engineer, the broker and the seller can create a solid foundation for both the valuation of the property and the subsequent negotiation of the offers to purchase. In the transaction reviewed in this article, the seller's advance-of-sale appraised value of \$4.1 million was very close to the two offers that were accepted (\$4.0 million and \$4.25 million).

Brownfield transactions require advance cooperation and coordination of all of the professionals hired by the seller and involved in advanced due-diligence activities. The result will be a transaction that has a higher probability of reaching the closing table, in a shorter period of time, with lower environmentally related transactional costs.

ENDNOTES

1. Alker, Sandra, "The Definition of Brownfield," *Journal of Environmental Planning and Management*, January, 2000.
2. Meyer, Peter B., "Lessons from Private Sector Brownfield Redevelopers," *Journal of American Planning Association*, Winter, 2000.
3. Foley and Lardwer, Brownfields working group, "We've Entered an Era of Common Sense," October, 1997.
4. *Journal of Accountancy*, "Official Releases," March, 1997.
5. E1527-00 Standard Practice for Environmental Site Assessments: Phase 1 Environmental Site Assessment Process.