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# Are Your Clients Getting What They Bargained For?

**Distressed properties' environmental risks may present unforeseen costs**

**OPPORTUNITY AND RISK AROUND IN** today's distressed-asset marketplace. As these assets become available, property investors often make decisions quickly and with limited due diligence. Although many investors are gaining confidence in the valuation of these assets, they also should consider the potential risks that could affect the exit value, the cost to maintain or the cost to manage. When working with clients interested in purchasing and financing a distressed property, commercial mortgage brokers must be aware of these issues and how these risks influence their clients' investment strategies.

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Environmental issues often have direct implications for a property's value. The cleanup costs or regulatory fines for non-compliance may exceed the property's estimated value. Additionally, environmental issues affect a property's marketability at a time when filling vacant units is critical. A goal of conducting preliminary due diligence is to make sure potential buyers discover issues before a lender discovers them and turns down the loan application — or your client is left holding the title to a property burdened with remediation needs.

Here's a look at the environmental issues you should help your investor clients consider before they acquire distressed properties.

## Risks by property type

Environmental concerns generally can be categorized by property type. Brokers who are aware of the issues that can affect each major asset class can help clients investigate these risks fully before committing to a deal.



Illustration: Dennis Wunsch

Here's what to look for in each property type:

- **Construction and development sites:** Pending stormwater violations and fines can cost tens of thousands of dollars per day, representing a significant concern for stalled development sites where grading activities removed the natural ground cover. Once a secured creditor takes title to the property, the local issuing authority often will resume enforcement of

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violations, knowing that there is now an opportunity to collect fines.

- **Multifamily:** The presence of lead-based paint or asbestos-containing materials can result in increased costs for any needed maintenance or planned renovations. Lead-based paint in particular can be a source of significant third-party liability for multifamily properties if painted surfaces are in poor condition. For asbestos, if materials are friable and must be abated, costs may skyrocket. Mold is another widespread concern for distressed multifamily assets. Deferred maintenance of building components such as roofing may cause water intrusion. Heating, ventilating and air-conditioning systems often are out of operation, which can lead to the presence of mold and associated third-party liability and tenant issues.
- **Retail:** Research the historical occupancy of retail centers to identify if a dry cleaner was previously present on-site. These facilities may cause soil and groundwater contamination. Based on the nature of dry-cleaning solvents, costs associated with the cleanup of contaminated groundwater can extend into millions. Vapor migration from dry-cleaning solvents and other volatile organic compounds into buildings from contaminated soil and/or groundwater also may occur. Gas stations present another environmental issue often encountered at retail properties. Good locations for fast-food restaurants or drug-stores historically also were good locations for gas stations. If fuel-dispensing activities ceased before regulation, it is possible that underground storage tanks were not closed in accordance with current regulations. Soil or groundwater contamination may exist unbeknownst to the current owner or lender.
- **Office and hospitality:** With distressed assets, owners may delay required maintenance of key systems such as hydraulic elevators. In older buildings, hydraulic fluid from elevators may contain polychlorinated biphenyls that can increase the cost associated with bringing the elevators back into operating condition — or may require soil to be excavated

from beneath the building. Investors should look out for the presence of asbestos, lead-based paint or water intrusion, which leads to mold. In the case of urban-infill-development locations, investors should know historical concerns associated with the property's prior use. The presence of these issues will cause increased renovation costs.

- **Industrial:** Potential liabilities associated with industrial sites are directly related to their current and past operations and the chemicals used. Soil and groundwater contamination may be present, even if the prior business complied with environmental regulations at the time of operation. Industrial solvents pose a particular risk because of their mobility in the subsurface, cost to remediate and third-party liability. Environmen-

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The environmental concerns detailed above are just a snapshot of the universe of potential environmental risk that can affect properties, particularly distressed assets. Regardless of the property type, it is important for potential buyers to understand the properties' complete historical use. Although current or recent occupants may not pose a concern, prior occupants could have been high risk and not previously identified.

### How value is affected

If environmental issues are uncovered, the investigation and cleanup costs may exceed the property's value. Brokers and their investor clients should not assume that proper due diligence was done for the last

purchaser. Often due-diligence requirements were rushed or waived in the prior market's irrational exuberance. Workout groups also may rely on the due diligence that was performed at the time of loan origination. Legacy environmental issues follow a property until properly resolved. New owners typically are on the hook for addressing open issues, particularly when former owners are no longer viable entities. In foreclosure scenarios, neglect and unaccountable borrowers can cause significant damage to a property during the workout process or before a receiver is appointed. These borrowers often are financially stressed or do not want to contribute additional funds to the property, and they may cancel compliance and maintenance activities. Intentionally damaging acts and negligence



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also may occur. Some businesses such as dry cleaners often cause contamination even when operating in full compliance with laws and may have not been present or have operated for a substantial amount of time during previous due diligence.

Vandalism at vacant properties also can damage assets or lead to releases of hazardous substances with costly implications. Proper care should be taken to maintain safety devices such as lighting. For vacant buildings and land, access to the property should be limited as much as possible.

Even when investing in notes rather than assets, the property's environmental condition should be considered. The end-game position of ownership and disposition of the asset may result in unknown exposure to environmental risks if a workout fails.

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## What to do

So how should brokers advise their clients to approach environmental due diligence for distressed properties? There are a range of options, depending on time constraints and availability of existing information. An environmental professional can perform desktop reviews of prior reports for portfolios of distressed assets or individual assets as needed. These reviews will be limited by the quality of the information presented, but a good consultant often can identify red flags through this process.

For assets with high environmental risk and for any asset where the client will hold an equity interest, a Phase I environmental

site assessment should be prepared. The environmental professional should approach the assessment with the investor's goals in mind. A Phase I environmental site assessment includes a property inspection; a review of the historical use through resources such as maps, aerial photographs and business listings; and agency research to identify the historical and current uses, operations and general compliance history. The assessment will identify whether contamination is present or likely present, and the consultant should provide guidance on how to approach any issues.

For industrial facilities, a more comprehensive compliance audit may be

prudent to identify potential costs to cure violations or properly decommission facility operations.

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Although no assessment is a guarantee that environmental issues won't be discovered in the future, conducting proper environmental due diligence will screen out most potential environmental risks and costs on the front end of a deal, allowing all parties to move forward with a better understanding of the asset's value. Brokers who are aware of the environmental hazards possible in distressed properties will be a valuable asset to their investor clients. ●