Demonstrating Value Through Proactive EH&S Due Diligence of Distressed Portfolios

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Abstract

With the ongoing COVID-19 impacts to many areas of the U.S. economy, some businesses will find the effects of the disruption too much to absorb. When those assets enter the commercial and industrial real estate market, potential buyers will need to navigate due diligence of the potentially distressed operation or property being considered for acquisition. Thorough due diligence is essential to ensure you are making a good investment and mitigating potential unknown risks.

To help navigate a distressed deal, we will provide some insight on:

- Effects of the COVID-19 pandemic and the opportunities for buying and selling commercial and industrial facilities (e.g., production facilities, warehouse, and distribution properties)
- Proactive strategies for conducting environmental, health, and safety (EH&S) due diligence on distressed assets and other properties
- Effective management of EH&S operational issues in distressed operations to avoid risks

What is a Distressed Operation or Asset?

With thousands of employees working from home, storefronts and industrial facilities shuttering doors, and business owners making cuts or reorganizing resources to stay afloat, the COVID-19 pandemic has opened the door to potential buyers and investors of distressed companies, assets, and properties. Recent surveys tracking the industrial real estate industry's response to the COVID-19 crisis showed significant gains in new development/redevelopment, building acquisitions, and deal activity. The Distilled Spirits industry is not insulated from this pressure.

Understanding the risks and opportunities associated with acquiring distressed assets are key to success for an organization considering expansion during this time. Part of the equation is understanding the environmental, health, and safety (EH&S) risks with distressed assets. Distressed EH&S due diligence is different from non-distressed or "traditional" environmental diligence activities. To begin with, the seller and possibly the property are in financial distress, which means cuts have likely been made to regulatory compliance oversight, and violations are more likely.

Distressed operations can mean:

- Business is operational but operations are not in compliance with all regulations, perhaps cost-cutting has affected activity or personnel designed to keep the operation in compliance.
- Non-compliant operation masks the actual cost of operation, inflating the true profitability of the operation, and posing a potential financial risk for the buyer.
- Non-compliant operation opens an unsuspecting buyer to the business risk of permit costs, and/or regulatory enforcement actions.

Distressed assets can mean:

- Business was initiated without proper due diligence, eliminating available protections to business owners.
- Property in enterprise zones may have environmental contamination which the new company bought into – in some cases, with or without environmental due diligence.
- Operations, even under a valid operating permit, have created compliance issues related to permitting, waste management, wastewater, health, safety, etc.

Purchasing a distressed asset or operation requires an investor or buyer with the ability to identify and manage risk, the capability to source and close deals from unpredictable directions, and the means to complete deals in unconventional ways. Thorough EH&S due diligence on a potential real estate purchase is recommended for all deals, but for distressed targets, it is the key to ensure you are making a good investment and mitigating unknown risks leading to potential costly consequences.

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Due Diligence is Important for Any Property

Environmental liability can exist at any type of site. It does not have to be a heavily industrialized area or property to come with "skeletons in the closet." What may seem like a good deal – a vacant warehouse or storefront – may have a few surprises that should be identified during proper environmental due diligence. For example, some properties we evaluate have unknown underground storage tanks, previously operated as a dry cleaner or service station, or were the location of manufacturing operations that used chlorinated solvents that eventually impacted soil or groundwater at the site. Even if the site itself was never used for an industrial purpose, a neighboring property could cause contamination to migrate to the site in groundwater.

An abandoned tank or floor drain with solvent residue discovered at a later date becomes the new owner's problem. As Maureen Bayer of EHS Support writes in her December 28, 2018 article *Environmental Due Diligence: Not Just for Industrial Properties*:

> Even a seemingly innocuous office building or warehouse constructed in the mid-2000s could have been the site of industrial activity in the past. If the history of the site is not carefully examined, even somewhat obvious recognized environmental conditions (RECs) may not be uncovered prior to the sale. If contamination is later discovered when the property is redeveloped, it could be too late to seek indemnification from the seller or responsible party. Moreover, the new owner would be strictly liable for the contamination under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA or Superfund). The current owner, having not conducted a Phase I Environmental Site Assessment (ESA) prior to the sale would not qualify for innocent landowner defenses because "all appropriate inquiry" was

not conducted before the sale. All appropriate inquiry (AAI) is one necessary element of the defenses available under CERCLA and requires an ASTM E1527-13[1] Phase I ESA prior to the sale.

For any property, it is important to understand the risks being transferred. Unknowingly purchasing contaminated property can result in liability for that contamination and if it is migrating to a neighboring property, then the liability could be devastating to the business.

The common practice for assessing the environmental condition of a property is the performance of a Phase I Environmental Site Assessment that follows the ASTM E1527-13 standard. ASTM E1527-13 requires Environmental Professionals to identify "all obvious uses of the property . . . from the present, back to the property's first developed use, or back to 1940, whichever is earlier" to identify RECs associated with the property. If contamination is not suspected because of the current land use, a Phase I ESA may not be necessary. A desktop review[2] of the property omits the site visit, but still includes a review of historical records with a less costly and quicker deliverable. Not to mention, it is more convenient during a pandemic, when contact and travel restrictions are still in place. The resulting assessments can then be built into the deal and will sometimes result in a lower purchase price if contamination is identified.

Have a Strategy for Conducting Due Diligence on Distressed Assets

When dealing with a distressed property, a simple four-step process to understand and mitigate risk of the unknown is recommended:

1. **Understand the property.** If you are considering a property purchase, conduct a Phase I ESA or desktop review. This will help you understand and mitigate environmental risks created by the previous owners/operators.
2. **Know if the facility is compliant.** Whether it be an illegal discharge to the municipal sewer or unpermitted air emissions, a highly effective way to gauge compliance and focus resources is to conduct an EH&S audit. In the interest of having a starting point, it makes sense that a high-risk operation is the first area of focus on Day 1.
3. **Develop a plan.** Once you identify risks during the Phase I ESA or audit, leverage existing resources with a solid plan and identify key people to prioritize aspects of the EH&S program. This will evolve your new company beyond perpetual makeshift solutions and close EH&S program gaps to improve your risk profile and increase operational efficiency.
4. **Implement the plan.** Many EH&S programs can be established and managed in-house with existing talent. It is important to focus on EH&S as an accountability for all, not merely a box on an organizational chart. You may be surprised by existing personnel who will step up if asked, or who care about the environment or safety performance, but have not been given clear direction on how to contribute.

When acquiring a distressed asset, it is important to include an evaluation of EH&S compliance during the due diligence process. EH&S compliance can be very complex – it is understanding laws, regulations, and codes and implementing those requirements at each operating commercial and industrial facility. It is safe

[1] American Standard Testing Materials (ASTM) E1527-13 Standard Practice for Environmental Site Assessments: Phase I Environmental Site Process

[2] While a desktop review does not qualify as AAI under CERCLA, if historical industrial uses are identified during the desktop review, the assessment can be expanded into a full Phase I ESA.

to assume that a distressed company diverted resources from EH&S programs to keep the business afloat, which may have costly repercussions for the new owner/operator on Day 1.

During these unique times, you should identify whether the distressed company has used any enforcement discretion or forbearance policies due to COVID-19 that provided relief if they were unable to comply with their permits or other operating conditions. Verification that policies apply to the new owner/operator will be necessary. If a Phase I ESA progresses to an environmental investigation of potential contamination (i.e., Phase II ESA), the buyer will want to know if there are any regulatory reporting obligations of the results and decide if they are willing to take on a cleanup. Many states continue to offer voluntary cleanup and redevelopment program (e.g., Brownfields) incentives to address any environmental contamination associated with a target property, but this should be determined before the buyer takes control and will not mitigate cost.

During the due diligence process, be prepared to hire professionals to assess or mitigate other potential business risk issues common with older facilities, such as poorly maintained asbestos-containing material or lead-based paint, or other conditions unfolding from lack of maintenance, such as mold from water damage or poor ventilation in a vacant building.

Effectively Manage EH&S Operational Issues

For any company, there is no such thing as unlimited resources and tools, so it is important to make the most of what you have. The plan developed as part of the due diligence process can leverage existing resources and personnel. The right mindset before Day 1 is key – be proactive, evaluate cost and resources, and organize and communicate the program's goals and objectives to those resources. Identify and focus your resources. Prioritize - what do you need to focus on first in your plan? What will have the most impact? What will have impact most quickly? When we look at the EH&S program, it can be overwhelming. Taking it piece by piece, evaluating the risks and potential outcomes (of action and inaction), and then prioritizing for maximum impact, can be a great starting point.

Show the Value of Proactive Diligence

Thorough due diligence on a potential real estate purchase is key to ensuring you are making a good investment and mitigating potential unknown risks. Find a partner that can navigate these issues and help you prepare for negotiating opportunities as the deal unfolds. In other words, with proper understanding of risks, and a better understanding of how these risks affect the real value of properties, the proactive company may position themselves to enhance their portfolio, even at discounted prices, while protecting their risk profile.

Do not neglect to include EH&S compliance during diligence. If the thought of an EH&S program seems too overwhelming, break the risks down into "tiers" or areas of focus. Every regulation is important, but focus your efforts as the first step. Keep in mind that every business is different, so the priorities at every business will be different, and the resources available at each business will not have the same skill set. Upon identifying needs, put people in place to have the maximum impact on Day 1.

EHS Support is a full service environmental, health, and safety consulting firm for a wide variety of industries. We offer site assessment, investigation and cleanup, environmental due diligence for industrial properties changing hands, and environmental and health and safety regulatory compliance guidance to our clients.

Amy Bauer is a Senior Compliance Specialist at EHS Support. Amy Bauer has over 20 years of experience conducting and managing environmental site assessments, regulatory compliance audits and support, and environmental investigations. As the Food and Beverage Sector leader for EHS Support, she helps our clients reduce risk, satisfy regulations, and lower their operating costs across a wide spectrum of industry challenges. As a Certified Professional Environmental Auditor (CPEA), Amy has performed various industry environmental compliance audits throughout the United States. Her specialty is helping clients interpret and implement complex regulatory compliance requirements.

Maureen Bayer is a Compliance Specialist at EHS Support. With over 15 years of experience in the environmental field and as an environmental attorney, Maureen serves as an invaluable asset to the EHS Support team by providing our clients with sound guidance they can trust. Maureen is experienced in guiding owners of contaminated property through the investigation, remediation, and cost recovery process; advising on environmental regulatory compliance matters in the areas of waste, water, and air; and advising clients on a range of environmental matters, including assessment of environmental risks in connection with complex business transactions in a wide variety of industries.