

## **The Brewing Economic Storm and the Role of Proper Environmental Due Diligence** **By David Copp\***

As most of us are aware by now, the Federal Open Market Committee (the “Fed”) is taking an aggressive stance to combat inflation in the economy, and has been raising the Federal Funds Rate at a pace and magnitude not seen since the 1970s and early 1980s, when inflation was last seen at these levels. This abrupt and significant rise in rates will cause the economy to slow down, although to what degree remains to be seen.

As an environmental due diligence professional since the late 1980s, and an armchair student of the markets since that time, I have been involved in several serious market downturns, most notably those in the early 1990s (manufacturing, housing and aerospace dislocations), the early 2000s (dot com boom/bust), and again during the Great Recession in the 2007-2009 timeframe. These downturns were deeper and lasted longer than many initially expected. Hopefully that will not be the case this time, but the risk of a significant dislocation appears to be present. Everyone in the lending community and downstream (receivers) needs to be prepared for what may be on the horizon: non-performing commercial real estate loans that will need to be evaluated and worked out in one way or another. During the pre-foreclosure review process is when the due diligence that was performed at loan origination - something that may have occurred several years ago - will have to be assessed.

During the 2007-2009 Great Recession timeframe, I worked as a consultant on dozens of pre-foreclosure assessments for a large regional SBA lender (and others) that made loans on many types of properties from residential tract developments to heavy industrial. Unfortunately, the due diligence that was performed, often at the peak of the market, was frequently inadequate both on the environmental and appraisal sides. There was apparently a “see no evil, hear no evil, speak no evil” mindset with the consultants and appraisers that were being used, and upon pre-foreclosure review, many properties were found to be both overvalued, as well as having previously unidentified environmental issues. On some of the loans, if the due diligence was inadequate, the SBA guarantee could also be in jeopardy. As a result of the many bank failures and takeovers during the 2007-2009 timeframe, federal lending criteria were tightened on the appraisal side, to mitigate some of these problems, but the environmental side remains less restricted.

When it comes to foreclosure or workouts, it is imperative the lender or receiver have a good understanding of the quality of the asset from an environmental standpoint. From my experience, you should take nothing for granted. Do not necessarily assume that either: 1) the loan origination due diligence was adequate, or 2) that the environmental conditions at the property (or in the neighborhood) remain the same as at loan origination.

Foreclosing on a property with environmental issues has many risks. Receivers play an important role in the process to evaluate the various, often complex, issues related to the property and creditors. Receivers must also be fair and limit the risk to the property and the various parties, including themselves. Obviously, having a team of experienced professionals to

assist the receiver in the various pieces of the puzzle for which the receiver may not be an expert is crucial to a successful disposition of the property.

When an economic dislocation occurs, it is vital to have highly experienced due diligence professionals assist you as part of the receivership estate. They can help you get a handle on the quality of the property, and minimize environmental risks.

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