

Reducing Lender Liability – The Importance of Defensible Environmental Due Diligence

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Environmental Due Diligence

- Protects a lender from future financial and third-party liabilities
- All Appropriate Inquiry (AAI) and ASTM Standard E1527-05
- Transaction Screen appropriate for certain properties

Causes of Environmental Losses

- Requiring less than an AAI Phase I
- Reliance on a borrower-supplied Phase I ESA report
- Environmental waivers by the lender based on the strength of the borrower even when there are Recognized Environmental Conditions (RECs)
- Inconsistent adherence to lender's environmental policy

Due Diligence Process

- Written environmental policy
- Initial background research by the lender
- Determine level of due diligence warranted
- Secure the services of an Environmental Professional
- Complete the assessment early in the process

Due Diligence Process

- Address RECs
- Additional requirements if SBA involved
- Vapor Intrusion not currently addressed by the standards, but should be considered
- Real Estate Lenders & Pollution and Remediation Legal Liability insurance
- Review loan portfolios on a documented, regular basis for environmental changes

REDUCING LENDER LIABILITY— THE IMPORTANCE OF DEFENSIBLE ENVIRONMENTAL DUE DILIGENCE

ENVIRONMENTAL DUE DILIGENCE, if done correctly, protects a lender from future financial and third-party liabilities.

Recent data show that many environmental losses are attributed to loans where less than a Phase I Environmental Site Assessment (ESA) is required, such as a Transaction Screen. The frequency of environmental loss is significantly higher when the lender relies on a borrower-supplied ESA report. Environmental waivers from loan officers are also a major source of environmental loss—the strength of the borrower is considered sufficient justification to not require Phase II testing at a site with a Recognized Environmental Condition (REC). Compliance with a lender’s environmental policy is found to be inconsistent—adherence to a sound policy is as important as a qualified environmental consultant.

- ◆ Adhering to the **All Appropriate Inquiry (AAI)** standards is required to secure liability relief under CERCLA (“Superfund”). A Phase I ESA that follows ASTM Standard E1527-05 is intended to meet AAI criteria.
- ◆ A Phase I ESA usually does not include asbestos, lead paint, mold, radon, endangered species, wetlands, fault or subsurface investigations, unless specifically requested.
- ◆ A Phase II assessment, which typically includes soil and/or ground-water testing, may be appropriate based on the types of REC’s identified during the Phase I ESA.
- ◆ A Transaction Screen is less rigorous and does not provide CERCLA liability relief, but it may be appropriate for some properties.
- ◆ There may be additional requirements if other lenders or government agencies are involved in the loan process.

The Environmental Due Diligence Process

- ◆ Each lender should have a sound environmental policy that is fully discussed with appropriate staff. Documentation of adherence with the policy during the due diligence process is recommended.
- ◆ Conduct initial research to get a general understanding of previous and current property uses and perceived level of risk. Is this a high-risk site (e.g., dry cleaner or gas station)? Does the lender have specific knowledge about the site or surrounding area? The degree of environmental risk is not related to the loan value.
- ◆ Decide the level of due diligence deemed appropriate. Is a Phase I ESA warranted? Do the potential risks outweigh the incremental cost difference between a Phase I and a Transaction Screen? What is the lender’s financial risk?
- ◆ Secure the services of an environmental consultant who meets the definition of an **Environmental Professional (EP)**. There are plenty of firms that utilize an EP to complete the site inspection for the same price as firms that utilize an EP for oversight only. Consider the value of a template, checklist approach versus an evaluation of each site individually by an expert.
- ◆ Complete the environmental assessment early in the process—the relative cost of a Phase I ESA is small compared to site surveys, property condition assessments, etc. Remember, the ESA results can be a deal breaker.
- ◆ Liability protection means that REC’s must be addressed. Sometimes it is appropriate to set aside funds in an escrow account until REC’s are addressed or a site receives a Notice of Compliance from a regulatory agency.
- ◆ There are separate requirements, in addition to AAI, if the **Small Business Administration (SBA)** is involved.
- ◆ **Vapor Intrusion (VI)** is currently not specifically addressed by AAI standards; however, VI should be considered.
- ◆ Real Estate Lenders Policy (RELPL) and Pollution and Remediation Legal Liability (PARLL) policies may be appropriate tools to provide increased lender protection.
- ◆ Review loan portfolios on a regular basis to verify that REC’s were addressed and that property use and tenant changes have not increased lender risk. Also, review and update the lender’s environmental policy as appropriate.