<u>Lending</u>

Foreclosing on Commercial Property?

Environmental Due Diligence is an Important First Step

By Derek Ezovski

Sometime around 450 BC, the Greek philosopher Socrates said that there is only one good, knowledge, and one evil, ignorance. Two thousand years later, U.S. financier Warren Buffet quipped, “In the business world, the rearview mirror is always clearer than the windshield.” Lenders who have unknowingly foreclosed on contaminated property and faced financial losses as a result will surely agree with both sentiments.

As the economy continues to sputter and more commercial real estate projects default, it is especially important to remember that foreclosures turn lenders into owners and that pre-foreclosure environmental due diligence goes a long way toward minimizing a bank’s risk, even if due diligence was conducted prior to loan approval. This is especially true for community banks, which probably don’t have vast financial resources or loan loss reserve funds with which to offset potential risk.

Due Diligence—Contaminated property securing a loan transaction can pose numerous problems for buyers and lenders, which is why most banks routinely screen properties for environmental risk as part of the underwriting process. What many banks may not know is that environmental due diligence takes on even greater importance during foreclosure, because, as an owner, the bank can be held liable for cleanup unless it takes steps to protect itself.

That protection comes in the form of a Phase I environmental site assessment prepared in accordance with the U.S. Environmental Protection Agency’s All Appropriate Inquiry rule or its equivalent, ASTM standard E 1527-05. As it does for borrowers, the inquiry protects lenders from environmental cleanup liability under the Comprehensive Environmental Response, Compensation and Liability Act (or state CERCLA-based programs) by allowing them to claim status as an “innocent landowner.”

Protocol—Property owners can claim the innocent landowner defense only if they conduct ‘all appropriate inquiry’ prior to taking title, which means the bank must conduct the Phase I before foreclosure, preferably as soon as foreclosure appears imminent (especially before tensions with the tenant escalate). While it's up to the lender to decide what level of due diligence is acceptable—both a transaction screen and a Phase I ESA will reveal valuable information about a site's contamination status—only an AAI- or ASTM E 1527-05-compliant Phase I renders any legal protection for the property owner.

In other words, if the bank wants to have all the environmental liability benefits afforded under AAI or equivalent state programs, it needs to have a Phase I ESA done prior to taking control or ownership of the property. "A full Phase I may not be 'necessary,' but relying on a transaction screen is unwise," says Peter Niemiec, an environmental attorney in Manhattan Beach, Calif. "The bank … should know as much as possible about the property's environmental condition. Also, determining if the borrower breached an environmental condition of the loan, which may enable the bank to sue for cleanup, may not be possible with a transaction screen."

"While transaction screens are still performed when evaluating a bank's environmental risk for new loans, they provide no protection from a foreclosure perspective," adds Michael Kulka, P.E., an environmental professional with PM Environmental.

Banks that require borrowers to perform a Phase I prior to loan approval typically have fewer surprises during a workout. But even if the borrower's initial inquiry rose to the level of an AAI/ ASTM E 1527-05-compliant Phase I, the report could be missing information the bank might consider critical, because typically the borrower hires the consultant to perform the initial inquiry, and the bank's risk tolerance is probably lower. Too, if the lender is seeking liability protection, the report has to be current—some components must take place within six months of the transaction date—and the bank must satisfy certain "user" requirements.

"Even if proper due diligence was completed on the front end, the bank must still complete property due diligence upon foreclosure to qualify for state and federal exemptions," explains Kulka.

Before the inquiry begins, lenders should consider whether the standard Phase I is sufficient. "The bank should be concerned with all items that could affect the property and its ability to sell post-foreclosure," says Mark Shearon, an environmental professional with Confluent Solutions. "They should instruct their consultants to present all potential concerns—even those that aren't so-called recognized environmental conditions—for disclosure and discussion to determine whether follow-up is necessary."

Lenders should also tell their consultant about any environmental covenants contained in the loan documents so evidence related to their possible breach can be gathered.

Non-Scope Items—Depending on a property's age and use, it may be prudent to include an evaluation of items that fall outside the scope of CERCLA liability. Lenders should discuss with their environmental professionals whether the property merits an inspection for mold, asbestos, lead paint, vapor intrusion, or other issues that can affect the value and salability of the property. The bank should consider non-scope items not only from a risk position but from one of marketability, because having certain issues quantified or resolved may enhance the sale of the asset. (If a Phase I was performed pre-loan, these items may already be resolved.)

Secured Creditor Protections—As most lenders are aware, CERCLA contains a secured creditor exemption that generally provides that a person who holds "indicia of ownership" primarily to protect its security interest will not be considered an owner of a property if it does not participate in the management of the facility. If the secured creditor forecloses on the property, it may still maintain its liability exemption so long as it takes steps to sell the property in a commercially reasonable manner.

The creditor may monitor the borrower's business or take other actions that a prudent lender would take without forfeiting its immunity to liability; however, if the lender exercises decision-making control over the borrower's environmental compliance, the exemption doesn't apply. Many lenders are understandably confused about secured creditor exemptions because the law is vague.

"When EPA promulgated its lender liability rules in 1992, the rule had a 'bright-line test' for when lenders had acted to divest the property in a commercially reasonably manner," explains Larry Schnapf, a New York-based environmental attorney. "Those regulations were vacated in 1994, and the 1996 statutory amendments to CERCLA and RCRA did not contain the bright line test. In its absence, lenders won't know if their actions are consistent with the exemption and may find themselves subject to scrutiny by individual courts."

“Lenders need to exercise caution during workouts,” continues Schnapf. “It is important for purchasers to evaluate the environmental conditions of the collateral prior to purchasing the note by performing a Phase I that complies with the EPA’s All Appropriate Inquiries regulation or the ASTM E 1527 standard. Purchasers should also consult environmental counsel prior to taking any actions that would be suggestive of exercising control over a potentially contaminated property.”

Bottom Line—Environmental due diligence is an important issue for banks to consider prior to foreclosure. Yet even if a bank has a weak or outdated environmental policy, all is not lost. “Lenders should be aware that just because proper due diligence was not completed when the loan was booked does not mean that they can’t protect themselves in the event of default,” says Kulka.

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