

New Due Diligence Needed for SBA Loans

Get to know the significant changes to the U.S. Small Business Administration's rules

By **Joe Derhake**, president, Partner Engineering and Science

THE U.S. SMALL BUSINESS ADMINISTRATION'S (SBA) Standard Operating Procedure No. 50-10(5), governing 504 and 7(a) loans, took effect on Aug. 1. One of the most-significant changes is the SBA's more prescriptive environmental policy, which will affect how lenders conduct environmental due diligence.

Brokers should be familiar with these changes to prepare clients and their properties to best meet these standards.

The most-significant changes include:

- **Use of North American Industry Classification System (NAICS) codes for determining when a Phase I environmental site assessment is required;**
- **Specific and extensive requirements for gas station due diligence;**
- **Use of a risk-assessment and records-search product for screening low-risk loans;**
- **Guidance on remedial-cost estimates;**
- **Required indemnity language of third-party indemnifiers; and**
- **Specific reliance letter.**

Here is a look at each of these items and ideas on how brokers can help lenders best implement the policies.

NAICS codes

Every business that deals in goods and services carries a NAICS code. If the collateral property is or was occupied by a business carrying one of the 58 enumerated NAICS codes — such as that of a dry cleaner, gas station or funeral home — a Phase I assessment will be necessary.

For clients looking to purchase a property, this creates the basic challenge of identifying the

NAICS codes of each of the property's tenants and past tenants. What companies have occupied the site for the past 50 years? Company names do not always reveal their use of the property. For example, what NAICS code would ABC Industries have carried?

Lenders will likely look to environmental professionals for assistance with identifying past-tenant NAICS codes, but clearly there will be instances where the precise use of the property is unknown. In these instances, the professional may recommend further due diligence.

Gas stations

The SBA is pulling back from its position as a primary guarantor of gas station loans. The SBA will continue to make loans but only if borrowers conduct robust environmental due diligence.

All gas stations now must have a Phase I site assessment plus a compliance audit. If a gas station is more than five years old, a Phase II subsurface investigation also is required. For example, for a six-year-old gas station, borrowers must pay for a Phase I environmental report, a compliance audit and a Phase II subsurface investigation. Borrowers should allow six weeks for these reports to be completed. In addition, borrowers face \$7,000 to \$10,000 in environmental due-diligence expenses — a substantial expense on small loans.

Risk assessment and records search

If the loan is more than \$150,000 and the property is not associated with one of the listed NAICS codes, then the minimum due-diligence product will be a risk assessment and records search. This is a risk assessment that a third-party environmental professional completes.

It must include a review of the following information:

- **Borrower-completed environmental questionnaire**
- **Environmental database**
- **Available historical reverse telephone directories**

On the Web

- **Small Business Administration's Standard Operating Procedures (SOP) 50-10(5) for "Lender and Development Company Loan Programs" (PDF):** tinyurl.com/sop50105
- **More SBA SOPs:** sba.gov/tools/resource/library/sops/

- **Sanborn fire insurance maps**
- **Historical tenant NAICS codes and a risk assessment** from an environmental professional with errors-and-omissions insurance

Can a bank's in-house environmental professional do the review? Not always. This is one of the controversial parts of the standard. In-house environmental professionals typically do not have errors-and-omissions insurance, which the new SOP requires. A strict interpretation would require that only third-party consultants could complete these reviews.

Lenders must order these reports from environmental consultants instead of directly from database companies. This will probably increase the cost by roughly \$100, but the lender gets a professional opinion in return.

Remedial-cost estimates

The SBA offers guidelines on preparing remedial-cost estimates (RCE) and underwriting real estate with known subsurface contamination. The SBA puts forward a thorough and reasonably conservative standard that allows lenders

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to finance contaminated real estate that historically has been hard to finance.

A qualified engineer can prepare an RCE if the plume is reasonably well-characterized and regulatory requirements are known.

The SBA requires lenders to hold back and escrow 150 percent of the estimate the consultant provides. These requirements are in line with what most sophisticated lenders are doing to underwrite contaminated property.


Third-party indemnity

Another tool in financing contaminated property is for the liability to be borne by a third-party indemnifier.

This story is common: A building is built over an old gas station, and a major oil company is handling the cleanup. The site is pretty close to closure but not there yet, and the borrower has indemnity from a financial giant. The SBA's allowance of the use of this indemnity makes the contaminated property more financeable.

The rub is that the SBA is specific on the language of the indemnity agreement, and major oil companies use substantially different language. A borrower likely cannot ask the oil company to rewrite its indemnity letter in a way that creates more exposure for the company.

Reliance letter

The SBA provides a specific reliance letter that the environmental professional must complete for limited products, such as the risk assessment and records search, as well as the Phase I environmental site assessment. 

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