

# **Guidance for Environmental Due Diligence in Loan Work Out**

## **Situations**

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Would you purchase a non-residential property without setting foot onsite? Probably not. Similarly, it does not make sense for a lending institution to take title to a non-residential property without conducting sufficient due diligence. Given the current economic conditions, lenders are facing many challenges in loan work out environmental due diligence and risk management.

### **Choosing the Right Type of Initial Due Diligence**

At loan origination and foreclosure, the main purpose of conducting environmental due diligence for the Lender is valuation of the collateral. The difference between origination and foreclosure due diligence is the Lender<sup>1</sup>, as owner, may chose to assume some liability for cleanup or maintenance to protect the value of the asset and/or to ensure the collateral is marketable. Given the current economic climate, the Lender may own the property and be responsible for continuing maintenance for months or years.

During origination, the extent of environmental due diligence completed is often dependent on several factors including loan amount, property type, anticipated uses of the property, and loan structure. An AAI (All Appropriate Inquire) compliant Phase I ESA may only be completed for high dollar loans, suspect property types, or acquisitions. For lower dollar

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<sup>1</sup> When the term “Lender” is used in this paper, it refers to a secured lender.

loans or high equity deals, less detailed and invasive forms of due diligence such as a regulatory database report or site questionnaire may be sufficient to access the property.

At foreclosure, a similar strategy of choosing the most appropriate level of initial due diligence for the property type should be implemented. An AAI Phase I ESA is likely the best choice for an industrial property, while a Transaction Screen Assessment (TSA) may be more appropriate for an office condo. Regardless of the loan amount, any type of due diligence that does not include a site inspection by an Environmental Professional should be avoided. Onsite conditions could have a material impact on the value and marketability of the asset.

### **Overview of Regulations that May Impose Liability and Responsibility**

Numerous Federal, State and Local regulatory frameworks exist to ensure protection of human health and the environment. These regulations setup a system for assigning responsibility for the release of pollutants into the environment, management of hazardous waste and remediation of contamination. The following regulatory requirements may impose liability on property owners including a lending institution:

#### **Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA):**

The CERCLA (aka Superfund Act) and the Small Business Liability Relief and Brownfields Revitalization Act assign liability for remediation to a property owner or operator of a facility that does not complete sufficient due diligence prior to purchase to identify contamination (All Appropriate Inquiry). A secured lender is excluded from CERCLA liability (secured creditor exemption) as long as the Lender does not “participate in the management of the facility.”<sup>2</sup> However, a Lender could still become liable under CERCLA under certain situations such as when arranging for the transportation of hazardous substances for disposal or treatment.

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<sup>2</sup> The secured lender must also hold indicia of ownership primarily to protect a security interest in the property.

**Resource Conservation and Recovery Act (RCRA):** The RCRA is a comprehensive strict program for the management of hazardous waste from initial generation, storage, treatment and transportation until it is finally disposed. This concept is commonly known as the RCRA “cradle to the grave” management system. Two additional programs exist under the RCRA statute including the solid waste program (non-hazardous waste landfills), and the Underground Storage Tank (UST) program. A lending institution does not have any liability exclusions under RCRA and can be directly liable for remediation of a RCRA hazardous waste or releases to soil and/or groundwater at a regulated facility. This includes liability for the proper disposal of materials remaining onsite post property transfer.

**Clean Water Act (CWA):** The Clean Water Act (CWA) was developed to reduce and control pollutant discharges to waterways. The CWA does not directly regulate groundwater issues. Instead, the CWA has tools to maintain the health of the nation’s water ways. The EPA has enacted pollution control programs including wastewater standards for industry under the CWA and the requirement to obtain a permit for discharges to water, including impacts to wetlands. The CWA is implemented through federal, state and local regulations. The CWA contains no secured lender exemptions. A Lender should be aware of which regulatory agency controls the permitting for a specific project and determine if there are any permits associated with the site, when the permit expires, and the requirements contained in the permit. You should also be aware that significant penalties for prior violations can be posted on a piece of real estate should it violate the issued permit. Examples include impacts to wetlands and land disturbing activities.

**Underground Storage Tank (UST):** Properties such as manufacturing facilities and convenience stores can have underground storage tanks (USTs) with petroleum or other regulated chemicals. There are significant requirements for the management of underground

storage tanks. As long as a Lender does not manage or participate in the management of an UST or UST system, they should remain protected under the security interest exemption. Participating in the management means “the holder is engaging in decision making control of, or activities related to, operation of the UST or UST system.” The state programs must follow federal statute; however, the state does have the ability to implement more stringent requirements than required by the Federal statute.

**Residential Lead-Based Paint Hazard Reduction Act (Lead Disclosure Rule):** Older properties may contain lead-based paint or lead-based paint hazards. The EPA and Department of Housing and Urban Development (HUD) have regulations that apply to sellers and lessors of residential housing to provide specific disclosures if the property was build prior to 1978. The Lead Discharge Rule requires disclosure of known lead-based paint and/or lead based paint hazards.

**State Requirements:** Most states are delegated the responsibility of implementing the federal requirements which are summarized above. States will also have their own state statutes and regulations which impose additional requirements. These state statutes may or may not have secured Lender exemptions. It is very important to be aware of these state requirements prior to foreclosing on collateral property.

### **Managing Risk**

There are many ‘problems’ in work out situations that Lenders should investigate prior to making a business decision to proceed with taking a piece of collateral into their owned real estate portfolio. In the forthcoming paragraphs a few of the most common concerns are outlined along with common key points to keep in mind.

**Contamination:** Contamination is loosely defined as a chemical or material that is present in soil or groundwater in exceedance of a limit established by the federal, state or local government. The primary purpose of environmental due diligence is to determine whether the subject collateral, which is often a Lender's second form of repayment in a loan default situation, is adversely impacted by onsite and/or offsite releases. Should the initial assessment (i.e. Phase I, TSA, GRS, etc. ) identify potential environmental risks that warrant further investigation, a Phase II soil and groundwater study will likely be the next step. The purpose of a Phase II investigation is to conduct a focused assessment of issues identified during the Phase I assessment. The Phase II investigation will typically identify environmental concerns through soil and groundwater sampling and analysis. The results of the Phase II assessment may result in the identification of necessary response actions. This information can be used to identify remediation costs and/or property devaluation.

While Lenders will usually have liability protection under certain laws and regulations, it is important to consider devaluation of a property since the purchaser of the property will not have the same liability protections as the Lender. Should a troubled asset be impacted by an onsite or offsite source, it puts a greater market stigma on the real estate that could impede the selling process of the real estate or reduce the marketable value of the property. As a result, it is prudent for a Lender to complete sufficient due diligence to quantify the potential post-foreclosure clean up costs. Once property transfer is complete, the Lender may want to take the proactive stance to clean up the property in the short term, so they can get the best return on investment when they sell the property.

Once the Lender is able to quantify the contamination (vertical and horizontal extent) by completing the due diligence assessments, develop a clean up plan, cost and time line, they

should be able to make a more educated business decision on whether it makes sense to take the property back into their portfolio and sell it. Should the contamination be extensive and the remediation costs are greater than the property value, the Lender may make the decision to charge down or charge off the property as a loss and not foreclose on it. Another option is for the Lender to sell the Lender note to a third party of interest for a discounted price, which will allow the Lender to recover some funds while never taking title to the real estate.

Typically, a lending institution wants to foreclose and sell the property in the shortest amount of time as possible. This allows the Lender to release the property and its subsequent issues including environmental from their portfolio once the site is sold to a qualified purchaser.

**Hazardous Waste Removal:** Due to RCRA's cradle to the grave regulations and lack of liability protection for Lenders, Lenders should be very hesitant to conduct activities that will generate hazardous wastes or sign hazardous waste manifests for the disposal of these wastes. If a Lender signs a waste manifest they are included within that "cradle to the grave" liability. Unfortunately, Lenders sometimes can not get away from signing waste manifests in a work out loan situation. During pre-foreclosure due diligence, the Lender should obtain a detailed itemized list of all chemicals located on the subject property. Along with this itemized list, the waste disposal contractor should be able to provide an estimate to have the material removed and properly disposed. To help reduce RCRA liability, the Lender should look at recycling, blending and incineration of all petroleum and hazardous material removed from the subject property. The Lender may also want to get guidance from their environmental attorney to ensure that the waste manifests are completed properly, the waste is being disposed adequately, and the material is handled in accordance with regulations that provides best protection to the financial institution.

**Stormwater and Erosion Control:** As indicated in the news in the last few years during this economic and residential down turn, erosion control and storm water management concerns are on the rise. Residential and commercial developers have abandoned properties in the midst of development typically due to lack of funding to complete the project. Often the developers have submitted a Notice of Intent with the regulatory authority to obtain a stormwater permit, and began construction by clear cutting the land, installing temporary stormwater basins, stormwater inlets and drainage channels. Once the project is abandoned, there is no one onsite to maintain these systems and therefore, they begin to fail. By the time the Lender gets involved or may become knowledgeable of the situation, there can be violations issued to the borrower which include fines.

A Lender should step in and complete necessary best management practices (BMPs) to reduce and/or eliminate fines and protect the value of the collateral in question. These BMPs could include repairing or replacing silt fencing, installing rip/rap or crush stone for proper sediment filtering, hydro seeding for soil stabilization, dredging out basins that may be full of sediment or water, and completing other necessary actions to keep the sediment on the subject property and not migrating offsite into regulated water ways. Often the regulators will agree not to impose the past unpaid fines on the Lender.

**Vapor Intrusion:** Vapor intrusion is one of the more recent hot topics and in some cases for good reason. When a volatile contaminant (such as gasoline) remains in the subsurface at elevated concentrations, there is a possibility that vapors from the contamination can migrate upwards into a building foundation causing indoor air quality and health issues to the building occupants. In many urban settings, known contamination at a property may have been previously investigated and the regulatory agency issued a no further action letter due to low risk of

exposure and the availability of city water and sewer connections. It is not uncommon for the regulatory authority to re-open a case due to the potential for vapor intrusion issues. This can also be a concern when the contamination is migrating onto the subject collateral from an offsite source. Whether it is an onsite or offsite concern, it still should be evaluated and, if necessary, addressed through engineering controls. The Lender should account for these potential post-foreclosure costs when completing the pre-foreclosure due diligence. In addition, the environmental consultant should determine if the source of the vapor issue has been identified and the sources removed. If not, further investigation may be warranted to further understand the source to help determine a resolution.

**Underground Storage Tanks (USTs):** In the event an UST system is present onsite, it is advisable to complete an inspection of the system, conducting a test of the leak detector and corrosion protection systems, and a Phase II prior to taking title. It is also advisable to determine if the tank system is covered by a leaking tank trust fund which is typically operated by the state. The ultimate goal of these investigations are to ensure the system is in compliance with regulations, to determine if the collateral has been environmentally impacted, and determine the cost to temporarily close the tanks. In order to remove the potential for contamination to occur for which the Lender will be responsible, immediately following property transfer, it is important to temporarily close the tanks or enter into a lease with the operator that specifies responsibility for the system. If a contamination release is known to exist at a UST facility, the Lender should fully understand the details of the release including the source, extent, responsible party in charge of funding clean up, cost of clean up and time line of clean up. All these factors are compared to the value of the property to determine whether foreclosure is a viable option for the Lender.

**Building Condition Issues:** Unfortunately, when money is tight, one of the first expenses that is often cut is building maintenance. Consequently, many distressed assets may have problems with water intrusion from leaking plumbing or roofs. Water intrusion will damage the building materials and could lead to mold growth. If these problems exist in an older building, the cost to repair the building could be much higher if asbestos containing materials or lead based paint is present.

In order to preserve the value of the building, post foreclosure, the source of the water intrusion will need to be repaired and the mold impacted building materials will need to be treated or removed. In order to quantify this cost prior to taking title to the asset, the following investigations can be helpful:

- Mold/Moisture Survey – The purpose of the survey is to determine the amount of water impacted building materials that will need to be removed / replaced.
- Limited Property Condition Assessment, Cause & Origin Study, Repair Bids – The purpose of this assessment is to identify the source of the water intrusion so that an accurate cost to repair can be obtained.
- Asbestos Survey and/or Lead Based Paint Survey – Often this can be limited to the materials that will be disturbed by building repairs.

**Third Party Liability:** One of the biggest hurdles to overcome when completing environmental risk management is third party liability. If contamination on a piece of Lender collateral is extensive enough that it results in the contamination plume migrating offsite and impacting third party properties, there are concerns of third party damages including toxic tort and offsite property devaluation, and other liabilities. The reason this issue is so hard to overcome, is that

one can not quantify this risk; therefore, it is hard to determine if there is enough equity to manage the risk post-foreclosure.

### **Conclusion**

"A Healthy Ecology is the Basis for a Healthy Economy"<sup>3</sup> - **Claudine Schneider**, U.S. Representative in *The Green Lifestyle Handbook*. As Lenders are commonly the drivers of environmental due diligence due to real estate transactions, they are also the typical triggers for environmental contamination being cleaned up in satisfaction to applicable regulations in order to achieve closure through the appropriate regulatory authority. One interpretation to Ms. Schneider's above quote is, if there is no environmental risk with a piece of real estate, the appraised value of the real estate is more accurate and the marketability of the real estate should not have an environmental stigma impeding a sale. This unencumbered process in return promotes a more sustainable real estate atmosphere. Unfortunately, environmental risk is real and must be evaluated and managed. In order to adequately evaluate and manage environmental risk associated with real estate, the completion of the proper level of environmental due diligence must be thoughtfully chosen as it can reduce the level of risk associated with a lending institution's owned real estate portfolio. A trained professional should be utilized to assist with the evaluation of non-residential properties prior to property transfer and assist the Lender navigate the complex regulatory process. Sufficient care should be taken to quantify the liability associated with 'problems' so that an educated cost v. benefit decision can be made prior to making the decision to foreclose.

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<sup>3</sup> [www.epa.gov/region2/library/quotes.htm](http://www.epa.gov/region2/library/quotes.htm)