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Change Is in the Air

Keep up-to-date with new environmental due-diligence requirements

ENVIRONMENTAL DUE-DILIGENCE PRAC-tices continue to evolve, and there were several significant changes that shaped the industry in 2011. These likely will continue to have an impact on how lenders operate this year.

Commercial mortgage brokers should look closely into changes in due-diligence requirements that pertain to Small Business Administration (SBA) and Freddie Mac loans, as well as changing standards from ASTM International, formerly known as the American Society for Testing and Materials. This information will help brokers guide their clients in purchase and financing decisions.

Freddie Mac changes

This past May, Freddie Mac made changes to its environmental due-diligence standards for multifamily properties. These changes were intended primarily to improve quality and consistency in the completion of Freddie's scope of work.

One new rule necessitates that environmental consultants address whether a state superlien law exists in the state in which the subject property is located. These laws allow states to place liens on properties that are superior to all current or future liens on the same property in response to environmental impacts. Lenders will be concerned about this because, if the property is contaminated and foreclosed on, the state would be the first to receive funds for remediation, rendering the mortgage worthless. Brokers should be aware of these issues when seeking financing.

Freddie Mac also has addressed issues associated with asbestos-containing materials (ACM) and operations and maintenance (O&M) programs. In particular, Freddie Mac will not accept opinions that ACM is not present based solely on the construction date, because asbestos continues to be used in certain building materials. Additionally, it requires a higher level of care when collecting samples for laboratory analysis to provide meaningful results as to whether ACM is present. Special consideration is paid to friable materials and materials in poor condition because these pose the greatest health risk. An O&M program may be recommended in lieu of sampling, provided that the correct number of units is observed and that suspect ACM is undamaged and non-friable or non-hazardous in its current form, condition or location. Because most consultants may not be willing to say that a property is free of asbestos, brokers should advise lenders to expect a recommendation for an O&M plan for most properties — unless the suspect ACM is damaged or in a hazardous state, in which case sampling would be required.

Freddie Mac has added a general requirement for the minimum number of units to be inspected and is focused on not just a percentage of units but also on addressing separate phases of construction. This is to ensure that a truly representative number of units is assessed or sampled for the presence of asbestos, lead-based paint, elevated-radon concentrations and mold. For example, at a six-building property where five buildings were constructed in 1986 and one building was constructed in 1975, the older building has a higher risk for asbestos and lead paint, but all buildings still must be assessed. These are common — and common-sense — practices that environmental consultants should already be adhering to but now are spelled out by Freddie's policy.

Additional changes impacting the typical due-diligence practices of consultants include a clarification of requirements related to polychlorinated biphenyls in nonutility-owned transformers and whether equipment should be removed or can be managed with an O&M program. There also were changes introduced to the multifamily environmental assessment form.

Understanding Freddie Mac's evolving environmental scope of work is critical to both commercial mortgage brokers and lenders' environmental consultants because any missed steps or overlooked policies could result in delays or additional costs for multifamily deals.

SBA changes

SBA lending continues to be an attractive vehicle for financing in today's market. The SBA also has specific environmental due-diligence requirements that have changed in the past year. In October 2011, the SBA updated their requirements for lender and development-company loans in standard operating procedure (SOP) 50 10 5(D). Here are some of the most significant changes.

- **The SBA clarified who may conduct a Phase I environmental site assessment (ESA).** A person who doesn't qualify as

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an environmental professional (EP) may assist in the completion of environmental due diligence under the All Appropriate Inquiry rule, if the person is under the supervision of someone meeting the definition of an EP. This is consistent with ASTM.

- **The SBA defined the term "multi-unit building"** to mean any nonindustrial multi-unit building that is comprised of four or more individual units.
- **Requirements for special-use facilities** also were clarified to specify "residential care facilities occupied by children," rather than those for the elderly or infirm. These facilities, as well as day cares, child care centers and nursery schools, require a risk assessment for lead-based paint and testing for lead in drinking water.
- **Car-wash-only facilities** are no longer lumped together with the North American Industry Classification System (NAICS) code for automotive repair and maintenance. Lenders are now allowed to start with the performance of a transaction screen as an acceptable starting point for these facilities, but only if there is no automotive repair or fueling activities associated with the car wash.
- **Gas-station requirements** also have changed. The SBA clarified that the gas-station requirements apply to any commercial fueling facility, which includes bulk-fueling facilities and car-rental facilities that fuel their own vehicles. A loan may not be provided until full compliance with state testing requirements is achieved. Previously, the SBA required documentation of equipment testing within 12 months of the date of the investigation. This change reflects the fact that state regulations regarding equipment testing are not consistent and that not all states require annual testing.

The rest of the SOP updates made this past October do not change the environmental investigation requirements significantly. This year, the SBA SOP 50 51 3 for loan liquidations may be updated, so brokers should be aware of any potential changes that could affect their deals.

ASTM standards

Most lender-specific environmental due diligence for SBA, Fannie Mae, Freddie Mac, U.S. Department of Housing and Urban Development (HUD), and other programs is based on one primary standard. This is used for the Phase I ESA scope of work and comes from the ASTM E1527-05 Standard Practice for Environmental Site Assessments. It was last updated in 2005.

The ASTM committee and task groups that oversee the revision process for the E1527 standard met this past year to discuss potential changes. Many commercial mortgage brokers, as well as lenders, consultants and attorneys, have followed this process closely because the results could significantly change environmental due diligence.

Here are some areas that are being discussed:

- **Regulatory file reviews:** There is debate over whether a regulatory-agency file review should be mandatory for sites that are listed in certain regulatory databases. This issue extends to whether agency file reviews also should include adjacent property listings. Although this requirement would raise the quality of some reports, it could be a big hurdle to coming to an agreement on an approach because of varying response times and availability of records at different regulatory agencies. Changes to the standard of requiring additional file reviews as part of the Phase I ESA process could have significant impacts on pricing, especially on sites with known issues or in industrial settings.
- **Clarification of definitions**: One issue at stake is whether to revise the definition of "release" to explicitly include contaminants in all phases, including the gas or vapor phase, which would put more emphasis on vapor-intrusion concerns. There also is interest in clarifying the definition of a historical recognized environmental condition (HREC). The term generally refers to reported release incidents that have received regulatory closure and are not considered to be a current concern, but there is confusion around the term. If a release incident was given regulatory closure under standards that were less stringent than current standards, should the incident be considered historical or current?
- **User requirements:** Who is the user of the Phase I ESA report? The word "user" was originally meant to refer to the prospective purchaser and those who would seek protection from liability from the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). In practice, many lenders are the ones relying on these reports to make business decisions, however. Lenders are not necessarily looking for CERCLA liability protection, so are lenders the users? If so, are they required to complete the user responsibilities? Often lenders do not have any knowledge of the subject property and will not complete user questionnaires for legal reasons. These issues carry many implications, including whether a large percentage of the Phase I ESA reports completed for lenders would be considered compliant with the Environmental Protection Agency's All Appropriate Inquiry rule.
- **Definition and role of the EP:** A constant topic of debate in the industry is the definition of an environmental professional and whether an EP should be required to conduct site inspections. An EP currently is defined as having five years of experience plus an appropriate degree. The Phase I ESA can be conducted under the supervision of an EP, which means that less-experienced personnel can conduct the site visit. The requirement for the EP to conduct the site visit could raise the quality of reports but likely would increase costs as well.

Many other points are being discussed, including non-scope items that are not required to be included in the Phase I ESA, like asbestos and lead-based paint.

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These discussions are expected to continue this year, as the committee continues to meet and vote on issues that could have a direct impact on the future of environmental due diligence. A decision on these changes likely won't be final until 2013.

Change is never easy, but if commercial mortgage brokers stay on top of changing environmental due-diligence policies, they can best advise their clients as to the work that needs to happen before financing can be secured. ●

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