

# Environmental Due Diligence and You:

## Creating and updating an environmental risk management policy



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The following guidelines, developed over time by multiple lending institutions through years of trial and error, can help you 1) create a new policy or 2) update an existing one to ensure it is in line with your bank's risk management goals.

### Why your bank should have an environmental policy

Environmental risk can have serious consequences:

- Loan defaults from financial obligations (cleanup costs and fines)
- Compromised redevelopment plans from property use limitations
- Injury claims from occupants of collateral or adjoining properties
- Irreparable damage to your bank's reputation, brand and image
- Environmental contamination can reduce the value of a property below the loan amount
- In the case of a foreclosure, it can delay the bank's sale of the property while the extent of the contamination is determined and an appropriate remedial action is identified

"It is...important for banks to have an environmental policy that requires some level of EDD," says Susan Phillips, an environmental lawyer with Mintz Levin.

"An environmental assessment helps to ensure that real estate used as collateral has the value the bank expects, since standard appraisals do not factor in environmental risk, and also elicits information on whether the borrower's ability to make loan payments could be compromised by a large environmental expenditure."

A sound environmental policy can help protect banks from credit risk and appease federal banking regulators, who have recently proposed guidance for banks and thrifts with high concentrations of commercial real estate mortgages. Another reason for lenders to consider is that the FDIC has updated its Guidelines for an Environmental Risk Program to include the EPA's All Appropriate Inquiry (AAI) rule.

The update 1) recommends that banks establish formal EDD policies in every instance of extending credit and 2) urges them to consider adopting AAI where appropriate. Other agencies, including the U.S. SBA, have followed the FDIC's lead and updated their environmental policies.



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“Banks should not lose perspective that they are largely exempt from exposure due to federal and state lender liability laws, provided they don’t take over environmental operations beyond protection of their security interest,” says Barry Trilling, an environmental lawyer with [Wiggin and Dana](#).

“All other factors being appropriate, banks should be able to address [EDD] issues with [Phase I environmental site assessments](#) (ESAs) that meet the basic [ASTM E1527-05](#) standard. Most important in doing so is hiring a qualified environmental professional who clearly understands the bank’s goals.

It is prudent for the lender to require the borrower to obtain a pollution legal liability insurance policy naming the bank as an additional insured to protect the bank’s interest if liability arises out of unknown conditions (i.e., those not discovered in a Phase I or [Phase II ESA](#)).”

### What to include

The goal of EDD is to understand the environmental risk associated with a transaction and then factor it into the overall credit analysis.

The bank’s business units can provide an understanding of the types of lending the bank does, the markets it serves, its business objectives and its risk appetite. (Some lenders tend to be risk averse, while others are willing to accept some risk to build market share or expand into new markets.)

Lenders can decide what their risk tolerance is by asking management how much money is considered material in the event of a loss or write-off and whether management is willing to accept collateral that is contaminated. Once lenders understand the bank’s business model and risk appetite, they can answer the following questions to help shape the environmental policy:

- **What type of property is typically used as collateral?** All real estate, regardless of use, can be affected by environmental issues. As a rule, commercial and industrial sites warrant more scrutiny than residential homes.
- **Where are lending activities concentrated?** Lenders should consider the region’s regulatory climate, geologic sensitivity, groundwater use and development trends. National and international banks can tailor policies to account for regional differences.
- **How old are the properties the bank typically lends on?** The longer a property has been in use, the greater the chance that on-site activities have led to contamination. Lenders should keep in mind, though, that pollution can migrate and contaminate raw land.
- **How big is the bank?** Small banks have more exposure. Conversely, because large banks have less exposure and can afford to keep experts on staff who can interpret environmental data, they can get away with less-conservative thresholds for EDD.

### Policy specifics

The following components are vital to a successful environmental policy and should be tailored to the bank’s objectives and risk appetite, once defined:

- **Objective:** Lenders should define why they have developed an environmental policy and include the business units or groups that must adhere to the policy.
- **Roles and responsibilities:** Lenders should clarify who must use the policy, who will enforce it, who can approve changes, and who has the right to waive it—and under what circumstances. Lenders should also define whose responsibility it is to review EDD reports. The bank should have a qualified manager designated as the chief environmental officer. This person would be responsible for 1) overseeing the environmental policy, 2) periodic updating, 3) training loan and credit officers and 4) identifying the criteria for the environmental consultants that are qualified to conduct environmental due diligence for the bank.
- **Personnel training:** Loan officers should be trained to identify types of properties and site conditions with elevated environmental risk. The training should be extended to loan administrators, credit officers and portfolio managers.
- **Types of properties subject to the policy:** All commercial real estate should be addressed in the policy. Environmental policies typically exclude one-to-four unit residential buildings. Banks often require due diligence for sensitive industries. Lenders should also consider including residential property suspected to have risks like mold or vapor intrusion.



*Environmental risk is a function of a site's current and past use and may not be reflected in its current value; thus, the degree of EDD should not be based on loan value alone.*

- **Scope:** Although the risk of environmental contamination resulting from releases of hazardous substances and petroleum should be taken into account by lenders in almost every financing where real property is used as collateral, contamination issues are not the only environmental risks a prudent lender may need to consider under the circumstances. "A comprehensive Environmental Risk Management Policy will have flexibility with respect to the scope of the due diligence review to be undertaken to allow for the evaluation of other potentially material environmental issues," says John Ix, an environmental lawyer with [Dechert LLP](#).
- **Risk analysis:** Lenders must identify which specific transactions require scrutiny. Large and regional banks typically require EDD for all properties taken as collateral. Properties of concern typically start with a sensitive industry list. The list typically used is the North American Industry Classification System, which is a required criterion for SBA loans.
- **Loan thresholds:** Lenders should define loan size thresholds for increasing levels of due diligence.
- **Ongoing monitoring:** Lenders should define 1) how often they wish to obtain updated information about environmental risks, indemnities and non-performing/troubled loan conduct and 2) what employees should do to ensure secured creditor protection.
- **Vendor/Environmental professional policy:** The vendor approval process should be spelled out and should include mandatory qualifications for outside environmental consultants. Banks may choose to set up an account with a database vendor that can provide search reports of environmental records.
- **Other considerations:** Lenders should spell out what levels of EDD and review are required for renewals, restructures and other subsequent transactions. Critical considerations include amount of new money, age of prior due diligence reports and any material changes in collateral condition or use. Lenders should also determine what levels of EDD and file review are required at the pre-foreclosure stage, and clarify responsibility for review prior to taking title.
- **Updating:** Lenders should decide on a policy-updating schedule. Most banks review the policy annually to ensure that it remains in line with the business model and goals, or sooner if warranted.

### Setting thresholds

Developing a tiered EDD approach is a critical part of writing the environmental policy.

Most lenders use an approach that progresses from a loan officer inspection form and borrower questionnaire to a records search with risk assessment to perhaps a more thorough tool (such as a transaction screen assessment) to a full-scale Phase I ESA that complies with the EPA's AAI rule or its equivalent, ASTM E1527-05 (or the current ASTM E1527 standard).

In cases where contamination is known or suspected, due diligence typically goes beyond a Phase I ESA and includes additional investigation, such as a regulatory file review, or preliminary sampling to scope out potential contamination and further sampling to characterize the extent of the problem (a Phase II).

In addition to setting due diligence thresholds, most banks require the borrower to sign 1) a Hold Harmless Agreement to indemnify from environmental liability for the subject property and 2) a Hazardous Substances Indemnity Agreement to address hazardous materials and spills on the subject property.

Each of the following tools has a place in a sound risk management program:

- Phase I and Phase II ESAs
- Transaction screen assessment
- Records search with risk assessment
- Site inspection form (loan officer) and borrower questionnaire
- Hold Harmless Agreement
- Hazardous Substances Indemnity Agreement

Lenders should note that the U.S. SBA has added a new level of EDD—[records search with risk assessment](#)—to its most recent policy update, [SOP 50-10\(5\)](#).



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### This tool includes:

- Search of all databases required under AAI
- Search of historical use records for the property and any adjoining properties
- Risk assessment (high or low) provided by an environmental professional

Lenders should create a chart of these tools to make it easier for their underwriters to make EDD decisions.

The chart should include variables like:

- The size of the transaction
- Perceived risk
- Historical environmental problems on the subject or adjacent properties
- Whether the transaction will later be sold in the secondary market
- Risk tolerance
- The level of environmental expertise available at the bank
- Whether the loan is guaranteed by the SBA
- Other criteria pertinent to the bank's business model

Environmental risk is a function of a site's current and past use and may not be reflected in its current value; thus, the degree of EDD should not be based on loan value alone.

If liability protection for the borrower under the [Comprehensive Environmental Response, Compensation, and Liability Act](#) (CERCLA) is important, only an AAI- or E1527-compliant Phase I ESA will suffice. To take advantage of any of the three liability defenses to CERCLA—1) the innocent landowner, 2) the bona fide prospective purchaser or 3) the contiguous property owner—property purchasers must have an AAI- or E 1527-05-compliant Phase I ESA prepared by a qualified environmental professional.

Although an AAI-compliant Phase I ESA is arguably the standard of care in environmental risk management, and many lenders require one for every transaction where a Phase I ESA is standard practice, it's not always practical.

Fortunately, database reports are effective screens that provide a quick, low-cost alternative. They can be used when CERCLA liability protection isn't a concern and the user has no reason to suspect that an environmental problem will arise. If suspicions are raised or problems are discovered, the lender can always increase the level of EDD.

### A word on foreclosures

There are a host of environmental considerations lenders will want to consider before foreclosing on real property collateral:

"A comprehensive Lender Environmental Risk Management policy should take into account applicable secured creditor protection laws and the due diligence lenders may need to perform to avail themselves of the protections afforded by such laws," says Abbi Cohen, an environmental attorney with [Dechert LLP](#).

"There also may be environmental issues for which the lender will not have post-foreclosure protection under federal- or state-secured creditor laws.

According to Cohen, "Certain state secured creditor protection laws do not insulate a lender from common law claims for bodily harm or property damage arising from hazardous substances on the property.

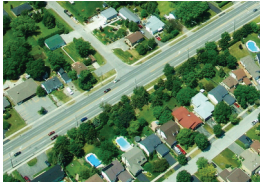
"Post-foreclosure, a lender operating a property may be legally required to comply with environmental permits, post financial assurance and meet other regulatory requirements.

"Accordingly, having a comprehensive Environmental Risk Management Plan can add value by identifying pre-foreclosure whether there are environmental conditions or features of the property that the lender will need to address post-foreclosure to minimize the risk of environmental claims, costs or liability."

### Lender Liability Act of 1996

The Lender Liability Act protects banks for environmental liability under CERCLA. This protection extends to lenders that do not participate in the management of the borrower's business and do not qualify as an owner or operator of an underground storage tank. The requirements to maintain the protection offered by this Act are identified in the Act and should be strictly followed. This requires education and training of loan officers and credit officers.





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## Waiver policy

A clear policy should be established to identify conditions where the credit approval authority can waive aspects of the environmental policy when conditions that mitigate environmental risk are present.

## Approving environmental professionals

Developing an approved list of environmental professionals presents yet another challenge. Lenders must decide what qualifications to accept (only those meeting the definition of “environmental professional” under EPA’s AAI rule can conduct AAI- or ASTM E 1527-05-compliant Phase I ESAs).

Lenders also must decide who will approve individual vendors, and who will review and maintain the list. They should also spell out whether they will accept reports from non-approved consultants and under what circumstances, and whether to accept existing reports and under what criteria—seller-prepared reports vs. bank- or client-prepared, reports on suspect properties, outdated reports, incomplete reports, etc.

## Additional Considerations

Lenders can fine-tune an environmental policy by addressing issues like:

- Whether to differentiate between high-risk properties (e.g., manufacturers) and low-risk properties (e.g., apartments)
- Whether they will lend on contaminated properties or gas stations
- How they will handle waivers
- Continuing obligations

The FDIC recommends that the lender’s environmental risk assessment extend over the life of the loan. This ties in with the EPA’s AAI rule requirement that property owners comply with continuing obligations over the course of property ownership, which preserves their ability to raise a liability defense under CERCLA.

Many banks’ environmental policies do not address this issue directly; nonetheless, they monitor properties by conducting regular site inspections and collateral assessments over the life of the loan. Lenders should consider whether this is sufficient for their bank. Lenders should also run the final draft of their environmental policy by an environmental lawyer or environmental professional to ensure that EDD guidelines 1) are in line with the bank’s overall risk management goals, 2) reflect standard practice and 3) are protective of the bank’ liability.

Bank personnel should read and understand the environmental policy and ensure senior management will enforce it.

Peer organizations and publications like the [Environmental Bankers Association](#) and [BNA’s Environmental Due Diligence Guide](#) offer relevant resources. Additionally, EDR posts continually updated information [on its main website](#) and on [commonground](#), an award-winning B2B social networking site for environmental lenders, lawyers and professionals.