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This document and any attachments are replaced by Comptroller's Handbook - Commercial Real Estate Lending

ENVIRONMENTAL RISK AND LIABILITY

The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws are important factors in evaluating real estate transactions and making loans secured by real estate. Environmental hazards can be a source of high risk and potential liability to an savings association and its subsidiaries (institutions) in connection with its real estate loans and investments. Potential environmental problems may exist in a myriad of forms such as asbestos insulation, underground storage tanks, surface impoundments, septic tank systems, or oil and gas wells.

Possible problems with pollution and hazardous waste contamination have grown as federal, state, and local governments have passed comprehensive environmental regulations and laws imposing liabilities on landowners and others for environmental cleanup. Institutions must be aware of and concerned with regulations that impose clean-up liability on an absolute or strict liability basis, particularly when governments have the right to assign liability to persons or entities no longer holding title to the property.

Risks that a lender can face as a result of environmentally contaminated property include:

- Collateral for a real estate loan or property to be acquired may be drastically reduced in value after discovery of a release of hazardous substances and/or petroleum products.
- The borrower may not be able to repay the loan if he or she must also pay for the cost of cleaning up the contaminated property. The cost for cleanup can be significant and may exceed the institution's encumbrance on the property.
- The real estate loan may lose priority to a cleanup lien imposed under the laws of those states that require super priority liens for the cost of cleanup. In each of these super lien states, a lien granted to the state securing the cost of cleaning up contamination may have priority over a lender's mortgage.
- The lender may be liable to the extent of any credit extended to any debtor who has operated property at which hazardous substances or petroleum products have been released, has generated such hazardous waste, or has transported it in an improper manner. This risk extends to all creditors, not just those who hold as collateral the property containing the hazardous substances and/or petroleum products.[1]
- The lender may become directly liable for the cost of cleaning up a site if it forecloses on a contaminated property, becomes involved in the management of a company that owns or operates a contaminated facility, or is involved in decisions pertaining to the handling of toxic or hazardous substances and/or petroleum products.

[1] Even if the lender were not directly liable, it would be at risk if the borrower was unable to repay the loan and the value of the property was impaired due to environmental liability.

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- The lender may not be able to pursue his or her foreclosure remedies and may have no practical alternative but to give up its loan security, and the right to recover on the loan itself. This could necessitate charging off the loan balance.
- The borrower may not maintain collateral or property with an environmental risk potential in an environmentally sound manner.
- Aside from the statutory penalties that can be imposed for toxic waste contamination, the potential liability for personal injury or adjacent property damage.

To address these potential risks and liabilities, institutions should develop a risk management program to evaluate, identify, measure, monitor, and control environmental risk and liability for all real estate loans.

Environmental Laws and Regulations

In January 2002, the Congress amended CERCLA (the Comprehensive Environmental Response, Compensation and Liability Act) to establish, among other things, additional protections from cleanup liability for a new owner of a property. The bona fide prospective purchaser provision establishes that a person may purchase property with the knowledge that the property is contaminated without being held potentially liable for the cleanup of contamination at the property. The prospective purchaser must meet certain statutory requirements and, prior to the date of acquiring the property, undertake "all appropriate inquiries" into the prior ownership and uses of a property. In November 2005, the Environmental Protection Agency (EPA) promulgated its "Standards and Practices for All Appropriate Inquiries" final rule, which establishes the standards and practices that are necessary to meet the requirements for an "all appropriate inquiry" (AAI) into the prior ownership and uses of a property. The AAI Rule became effective on November 1, 2006.

An environmental evaluation of the property that meets the standards and practices of the EPA AAI Rule may provide the borrower with added protection from CERCLA[2] cleanup liability, provided the borrower satisfies other requirements for Landowner Liability Protections. This protection, however, is limited to CERCLA and does not apply to the Resource Compensation and Recovery Act (RCRA), including liability associated with underground storage tanks, and other Federal environmental statutes, and, depending on state law, state environmental statutes. In addition, such an environmental evaluation may provide a more detailed assessment of the property than an evaluation that does not conform to the EPA All Appropriate Inquiry Rule.

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[2] Note: AAI is not required for lender protection under CERCLA and that lesser investigations may be adequate to protect a lender from related business risks.

Guidelines for an Environment Risk Program

An institution that is actively engaged in real estate lending (including loans to finance nonresidential and multifamily properties, as well as construction and acquisition and development loans) should assess it's exposure to related environmental risks and liabilities. Such institutions should develop and maintain an environmental risk program that:

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- Identifies, evaluates and monitors potential environmental risks associated with its lending operations.
- Establishes procedures to determine the extent of due diligence necessary to protect the institution's business interests.
- Assesses the potential adverse effect of environmental contamination on the value of real property securing its loans, including any potential environmental liability associated with foreclosing on contaminated properties.

The environmental risk program should provide for staff training, set environmental policy guidelines and procedures, require an environmental review or analysis during the application process, include documentation standards, and establish appropriate environmental risk assessment safeguards in loan workout situations and foreclosures.

The program should be commensurate with the size and complexity of the institution's operations. Institutions that have a heavier concentration of loans to higher risk industries or localities of likely contamination should implement a more elaborate and sophisticated environmental risk program than other institutions. The board of directors should review and approve the program and designate a senior officer knowledgeable in environmental matters responsible for program implementation.

Environmental Risk Policy

When environmental risk exposure is material, the institution should develop and implement written policies and procedures to manage environmental risk. The institution's policies and procedures should reflect adequate consideration of the Environmental Protection Agency's (EPA) "All Appropriate Inquiry Rule." Such a policy should incorporate several key elements, including:

- An analysis of current environmental laws and due diligence requirements for borrowers and the institution.
- A level of due diligence internally required in all real estate loan transactions.
- Risk thresholds based on property type, use and loan amount for determining when and what type of due diligence is required.
- Varying due diligence methods depending on the type of loan, the amount of the loan and the risk category, including borrower questionnaire or screening, site visit, government records review, historical records review, testing or inspections using qualified professionals, Phase I

environmental assessment (ASTM standards), and Phase II environmental assessment.

- The potential for significant impact resulting from the presence of hazardous building material such as asbestos and lead-based paint
- Appraisal requirements for disclosing and taking into consideration any environmental risk factors.
- Criteria for evaluating environmental risk factors and costs in the loan approval process.
- Criteria for determining the circumstances in which the institution would normally decline loan requests based on environmental factors.
- Environmental provisions for incorporation into transaction documentation:
  - For commitment letters: extent of due diligence required, borrower costs, approval contingencies, reporting obligations, documentation requirements, etc.
  - For loan documentation: reps and warranties, inspection requirements, reporting requirements, lien covenants, indemnification provisions, and provisions allowing for the acceleration of the loan, refusal to extend funds under a line of credit, or exercise other remedies in the event of foreclosure.
- Collateral monitoring and periodic inspection requirements throughout the loan term for properties with higher environmental risk.
- A means of evaluating potential environmental liability risk and environmental factors that could impact the ability to recover loan funds in the event of a foreclosure.
- Guidelines for maintaining lender liability exemptions, avoiding owner/operator liability, and for qualifying for Landowner Liability Protections under CERCLA and AAI if the institution acquires ownership of the property.
- Guidelines and controls to ensure the institution's adherence to safety and soundness principles.

In addition, with appropriate legal assistance, institutions should revise mortgages, guarantees, indemnities, contracts, and other loan documents to mitigate the risks of potential environmental hazards.

Training. The environmental risk program should incorporate training sufficient to ensure that the program is properly implemented and followed and that appropriate personnel have the knowledge and experience to determine and evaluate potential environmental concerns that might affect the institution. Whenever the complexity of the environmental issue is beyond the expertise of the institution's staff, the institution should consult legal counsel, environmental consultants, or other qualified experts.

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Preliminary Environmental Risk Analysis. A preliminary environmental risk analysis should be conducted during the application process. An appropriate analysis should allow the institution to avoid loans that result in substantial losses or liability and provide the institution with information to minimize potential environmental liability on loans that are made. Much of the information needed for the preliminary environmental risk analysis may be gathered by the account officer when interviewing the loan applicant concerning his or her business activities. It is also useful for an institution to develop an environmental risk questionnaire that is completed and signed by the buyer. The questionnaire should be designed to obtain relevant environmental information, such as the present and past uses of the property and the occurrence of any contacts by Federal, state or local governmental agencies about environmental matters. Federal, state and local records are often a good source of information about the property, prior owners, and whether any environmental liens or letters have been issued.

It may also be necessary for the loan officer or other representative of an institution to visit the site to evaluate whether there is obvious visual evidence of environmental concerns.

The preliminary analysis should identify high risk sites in which additional environmental due diligence is warranted. Performing an AAI Phase I analysis affords environmental liability protections to the borrower, which would protect their cash flow in the event of a mandated environmental cleanup.

An AAI Phase I to an institution is no different from any other form of environmental due diligence in that it is done for business risk purposes. Lending institutions typically reserve the Phase I for large balance and higher risk CRE transactions in order to be competitive on small balance deals. When they begin dealing with higher risk properties and large transactions they will typically require a Phase I because it is comprehensive and environmental liability protections are made available to the property owner/borrower. The institution should ensure that the Phase I analysis is performed to the new AAI standard.

Structured Environmental Risk Assessment. Whenever the application, interview, or visitation indicates a possible environmental concern, a more detailed structured investigation by a qualified individual may be necessary. This assessment may include any or all of the typical components of phase I and phase II assessments including, surveying prior owners of the property, researching past uses of the property, inspecting the site and contiguous parcels, and reviewing company records for past use or disposal of hazardous materials. A review of public records and contact with Federal and state environmental protection agencies may help determine whether the borrower has been cited for violations concerning environmental laws or if the property has been identified on Federal and state lists of real property with significant environmental contamination.

As part of its environmental risk analysis of any particular extension of credit, an institution should evaluate whether it is appropriate or necessary to obtain additional environmental due diligence and possibly require an environmental evaluation that meets the standards and practices of the EPA AAI Rule. This decision involves judgment and may be made on a case-by-case basis considering the risk characteristics of the transaction, the type of property, and the environmental information gained during an initial environmental risk analysis.

The decision to require the borrower to perform a property assessment that meets the requirements of the AAI Rule should be made in the context of the institution's overall environmental risk program. An

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environmental risk program should be designed to ensure that the institution makes an informed judgment about potential environmental risk and considers such risks in its overall evaluation of all risks associated with the extension of credit. The decision concerning when and under what circumstances to obtain additional environmental due diligence should be tailored to the needs of the lending practices of the institution. Individuals involved in administering an institution's environmental risk program should become familiar with these statutory elements. One source for information concerning the EPA All Appropriate Rule is the EPA website at http://www.epa.gov/brownfields/regneg.htm.

Monitoring. Institutions should consider ongoing assessment of the environmental risks during the life of the loan by monitoring the borrower and the real property collateral for potential environmental concerns. The institution should be aware of changes in the business activities of the borrower that result in a significant increased risk of environmental liability associated with the real property collateral. If there is a potential for environmental contamination to adversely affect the value of the collateral, the institution might exercise its rights under the loan to require the borrower to resolve the environmental condition and take those actions that are reasonably necessary to protect the value of the real property.

Loan Documentation. Loan documents should include language to safeguard the institution against potential environmental losses and liabilities. Such language might require that the borrower comply with environmental laws, disclose information about the environmental status of the real property collateral and grant the institution the right to acquire additional information about handling and the potential release of hazardous substances and/or petroleum products by inspecting the collateral for environmental concerns. The loan documents might also provide that the institution has the right to call the loan, refuse to extend funds under a line of credit or foreclose if the release of hazardous substances and/or petroleum products is discovered at the real property collateral. The loan documents might also call for an indemnity of the institution by the borrower and guarantors for environmental liability associated with the real property collateral.

Involvement in the Borrower's Operations. Under CERCLA and many state environmental cleanup statutes, an institution may have an exemption from environmental liability as the holder of a security interest in real property collateral. In monitoring a loan for potential environmental concerns, and resolving those environmental situations as necessary, an institution should evaluate whether its actions may constitute "participating in the management" of the business located on the real property collateral within the meaning of CERCLA. If its actions are considered to be participation in the management, the institution may lose its exemption from liability under CERCLA or similar state statutes.

Foreclosure Considerations. An institution's exposure to environmental liability may increase significantly if it takes title to real property held as collateral. An institution should evaluate the potential costs and liability for any release of hazardous substances and/or petroleum products in conjunction with an assessment of the value of the collateral in reaching a decision to take title to the property by foreclosure or other means. Based on the type of property involved, the institution should consider including as part of this evaluation of potential environmental costs and liability an assessment of the property that meets the requirements of the EPA AAI Rule.