

6 Things to Know About Environmental Due Diligence: From a Lender's Perspective



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Financial institutions require the completion of environmental due diligence of a commercial real estate collateralized lending transaction for many reasons. They may wish to understand the environmental condition of the proposed collateral and ensure a Borrower's compliance with applicable regulations prior to making a loan; to reevaluate the collateral during a renewal or refinance transaction; to determine the collateral's condition at the time of a loan default; or to obtain information about an unexpected environmental condition encountered within the loan term.

An ASTM Phase I Environmental Site Assessment is commonly completed in each of these situations to understand the environmental condition of a property and determine if further evaluation is warranted. Although the same report is prepared, environmental due diligence requirements can differ based upon the Client's risk tolerance and perspective; whether the assessment is performed for a purchase, renewal, refinance, or potential foreclosure real estate collateralized lending transaction; if a governmental agency such as SBA, Freddie Mac or Fannie Mae is involved; and if the property ownership or use will change after the assessment is performed.

The assessment process is further complicated due to timing constraints mandated by purchase and sale agreements, tax regulations, and bankruptcy proceedings; financial penalties for delayed closings; and the involvement of various stakeholders including clients, other financial institutions, township officials; additional environmental consultants; brokers, real estate agents, sellers, and legal counsel.

Every lending transaction requires different perspectives when evaluating environmental risk. To ensure the bank makes informed lending decisions, and a Borrower's compliance with applicable regulations, it is critical to incorporate six (6) important steps in any environmental due diligence transaction;

1. Understand the transaction dynamics.
2. Identify who will receive the report.
3. Capture the right information. Current information is necessary; historic information is valuable.
4. Recognize that environmental due diligence can be different than strict regulatory compliance.
5. Understand that environmental risk evaluation can go beyond the present day.
6. Practice regular and consistent communication during the process.

Let's examine each of these in more detail.

1. Understand the transaction dynamics

Understanding the transactions dynamics is important to ensure the correct scope of work is conducted and appropriate recommendations are made. For example, SBA, Freddie Mac and Fannie Mae have certain requirements beyond the ASTM standard. If the use of the property will change following completion of the report, additional actions may be necessary to ensure compliance with its new use. Local regulations may require non-ASTM-related actions at the time of a property transfer, such as evaluation of septic systems, sampling of potable wells, and UST tightness testing. Potential foreclosure evaluations may need to consider decommissioning costs and the potential for neglect in the years preceding the foreclosure action.

2. Identify who will receive the report

In order to qualify for liability protections under USEPA's AAI ruling, a report must be ordered by a perspective purchaser. It cannot be ordered by the seller, the broker, the real estate agent, or the financial institution. In addition, it is not always beneficial for a financial institution to order the report, especially when more than one financial institution is under consideration for the lending transaction or when a property is undergoing active remediation. In these instances, a Borrower could be left with an unusable report in the event the lending transaction falls through.

3. Capture the right information. Current information is necessary; historic information is valuable.

Reports need to be current to evaluate the environmental condition of a property and/or comply with certain regulations, such as the USEPA AAI ruling. This timeframe can be particularly difficult with large redevelopment projects, properties under a foreclosure action, or properties within a known environmental issue. However, conditions can change over time, sometimes immediately in the event of a catastrophic incident. The majority of releases do not garner media attention and would otherwise be unknown if a current report was not prepared. With this being said, historic information is valuable and should always be provided during the assessment process. It may shed light on a historic issue or not be otherwise available in public records.

4. Recognize that environmental due diligence can be different than strict regulatory compliance.

There are many examples of local, state, and/or federal regulations not covering items that could be potential liabilities, including floor drain discharges, USTs storing a fuel for on-site consumption; small USTs and ASTs; hydraulic lifts, and septic systems. All of these items could impact subsurface conditions, despite not always being regulated.

5. Understand that environmental risk evaluation can go beyond the present day.

It is important to consider the potential for collateral impact during the loan term. Examples include:

- An abutting gasoline station with no known releases, but its USTs are approaching their life expectancy.
- An industrialized neighborhood with the potential for future high-risk operations.
- A nearby property with ongoing investigation and remediation actions or with numerous violations or other indications of hazardous waste mismanagement.

In each of these instances, comprehensive information is invaluable to make an informed decision.

6. Practice regular and consistent communication during the process.

Most financial transactions are under time constraints per legal agreements, loan documents, tax regulations or life events, and the parties involved may incur financial penalties for delayed closings. Submitting reports on time and communicating delays in a timely manner is critical to ensure the environmental assessment process remains on track and all parties are kept informed of issues that may impact any timing constraints.

In Summary

Managing the environmental due diligence process is critical to ensure the success of any commercial real estate transaction. EFI Global can help you navigate these challenges and assist in your environmental / engineering due diligence requirements by performing due diligence services in a timely basis with a client focused approach, and addressing the environmental issues from a client's perspective and risk tolerance level. We will address engineering due diligence requirements in an upcoming white paper.

Our multi-disciplined team of experts and extensive geographical reach allows us to apply knowledge on an international scale. We consult directly with commercial mortgage backed securities (CMBS), balance sheet and agency lenders, property owners, REITS, agency, and attorneys to identify potential environmental concerns based on a review of a property's history, site reconnaissance, and regulatory records.

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