What's a Lender to Due?

A WHITE PAPER ON LENDERS' ENVIRONMENTAL DUE DILIGENCE

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LENDER ENVIRONMENTAL INSURANCE SOLUTIONS

Entities that hold mortgages on property as secured lenders such as banks, credit unions, mortgage bankers, conduit lenders, bridge lenders, life insurance companies and private investors may have differences as to the types, sizes and terms of loans, but they all often have one thing in common - the issue of known, perceived or future environmental contamination at a collateral property.

Environmental contamination may have significant negative impacts on the value of real property collateral and could lead to potential liability for the lender under various federal, state and local environmental laws.

Issues emanating from environmental contamination that have plagued lenders include the prevention of the loss of collateral property value and the avoidance of lender liability under environmental laws.

To avoid lender liability under environmental laws, many lenders perform some level of environmental due diligence, usually something like a Phase I Environmental Site Assessment or an electronic environmental database review - **but what does that really do?**

Environmental Laws and the Impact to Lenders

The primary environmental law property owners/ borrowers and lenders look at is the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), also known as Superfund, and its subsequent amendments by Superfund Amendments and Reauthorization Act of 1986 (SARA).

It is clear under CERCLA and SARA there are established standards for due diligence that can enable a property owner to qualify for defenses against liability under CERCLA. Lenders that hold indicia of ownership primarily to protect a security interest and who do not participate in management can be afforded a safe harbor from both pre- and post-foreclosure CERCLA liability, so their due diligence efforts do not need to be at the same level as those of the property owner.

Although the safe harbor or immunities from CERCLA may limit a lender's liability for pollution cleanup for contaminants discovered during a default or foreclosure, there are remaining exposures to the lender where the CERCLA immunities offer no protection.

Lenders can be left with no protection against:

- The decline in collateral property value due to the cost of remedial activities
- The loss of value from negative public relations
- Third party bodily injury and property damage claims resulting from exposures to the contaminants.

So even with CERCLA immunities, a lender with a default or foreclosure can suffer compromise of their collateral property value and be stuck with liabilities arising from certain federal and state environmental laws or from third parties.

How does a lender protect themselves against the loss of collateral value or from environmental liability? The answer is an appropriate Environmental Risk Management Program (ERMP). Although it might not be foolproof, an ERMP will go a long way toward mitigating environmental risk.

Environmental Risk Management Program (ERMP)

An appropriate and effective ERMP should reflect the lender's lending activities and its risk tolerance in addition to applicable environmental laws (e.g. there would be different environmental laws impacting an industrial facility than there would be impacting an apartment building). ERMP considerations should include:

- Regulatory Policy - determined by FDIC and the Office of the Comptroller of the Currency (OCC)
- Bank Policy - reflection of each lender's specific risk tolerance which should be in writing and adhered to
- Risk Potential - different for each type of loan

Developing an effective ERMP requires a good review of the lender's operations and realistic assessment of risk. The lender's safe harbor from certain CERCLA liabilities does not require them to meet the standard of EPA's "All Appropriate Inquiry"(AAI). There are times, for a lender, when that level of due diligence is appropriate; however, there are many times when that AAI level investigation is not necessary. With this in mind the lender should look at creating a written ERMP that is commensurate with the lender's lending profile and risk tolerance.

Due Diligence

The due diligence aspect of the Environmental Risk Management Program is often best articulated through a matrix. The matrix can include collateral property type, loan amount, type of loan (new or refinance) and the various types of due diligence appropriate for the given loan dynamics (see figure 1 for a sample template).

Types of due diligence that can be considered appropriate for various loan dynamics in the Environmental Due Diligence matrix include:

- Phase I Environmental Site Assessment (P1)
- Phase II Environmental Site Assessment (P2)
- Electronic Environmental Database Review (ED)
- Environmental Questionnaires (EQ)
- Environmental Insurance (EI)

Figure 1: Environmental Due Diligence Matrix Template

Loan Type	Property Type	Loan Amt Range	Loan Amt Range	Loan Amt Range	Loan Amt Range
New Origination	Multi-Family				
	Retail				
	Office				
	Mixed-Use				
	Light Industrial				
Refinance	Multi-Family				
	Retail				
	Office				
	Mixed-Use				
	Light Industrial				

Note: the recommended type of due diligence would be identified in each box under the Loan Amount Range. See Figure 2 for a sample completed Environmental Due Diligence Matrix.

Figure 2: Example of Completed Environmental Due Diligence Matrix

Loan Type	Property Type	Loan Amount				
		<$500K	$501K- $2M	$2M - $5M	$5M-$10M	>$10M
New Origination	Multi-Family	EQ EI ED	EQ EI ED	EQ EI ED	EQ EI ED	EQ EI ED P1
	Retail	EQ EI ED	EQ EI ED	EQ EI ED P1	EQ EI ED P1	EQ EI ED P1
	Office	EQ EI ED	EQ EI ED	EQ EI ED	EQ EI ED	EQ EI ED P1
	Mixed-Use	EQ EI ED	EQ EI ED	EQ EI ED P1	EQ EI ED P1	EQ EI P1
	Light Industrial	EQ EI ED	EQ EI ED P1	EQ EI ED P1	EQ EI ED P1	EQ EI P1
Refinance	Multi-Family	EQ EI ED	EQ EI ED	EQ EI ED	EQ EI ED	EQ EI ED P1
	Retail	EQ EI ED	EQ EI ED	EQ EI ED	EQ EI ED	EQ EI ED P1
	Office	EQ EI ED	EQ EI ED	EQ EI ED	EQ EI ED	EQ EI ED P1
	Mixed-Use	EQ EI ED	EQ EI ED	EQ EI ED	EQ EI ED P1	EQ EI P1
	Light Industrial	EQ EI ED	EQ EI ED	EQ EI ED P1	EQ EI ED P1	EQ EI P1

Lender Environmental Insurance

An often overlooked due diligence option for an ERMP is the use of Lenders Environmental Insurance. Lenders Environmental Insurance has many benefits not found with other forms of due diligence, including:

- Protection of lender assets by protecting against the loss of collateral value
- Transfer of lender environmental liability from the lender to an insurance company
- Better management of cash flow
- Streamlining of the loan process
- Enhancement of capital market deals

The benefits of lender environmental insurance are important as CERCLA immunities only apply to cleanup liability not to third party claims, and don't protect against the loss of collateral property value or protect the transportation of waste from a collateral property. CERCLA immunities also do not apply to other environmental laws where liability can be incurred, including:

- Resources Compensation and Recovery Act (RCRA)
- Underground Storage Tanks
- Clean Air Act
- Clean Water Act
- Toxic Substances Control Act

These are just a few environmental laws that might impact a lender when foreclosing on a property and which could be offset by the use of lender environmental insurance.

Lender environmental insurance provides commercial lenders with an alternative environmental due diligence that includes protection not found in other forms of due diligence and not afforded under CERCLA immunities. Coverage can be structured to meet the needs of a lender.

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John has held a variety of positions in the risk management and insurance industries. He offers a diverse background in property & casualty insurance, risk management, engineering, finance and business ownership. John started the environmental practice for a top 50 broker and as the Environmental Practice Leader developed several unique, complex environmental programs from start-up and became a national leading producer for Lender Environmental Insurance. Since 2000, John's primary business has been the management and placement of Environmental Insurance products with a large part of that focus on work with commercial lenders.

About LEIS

Lender Environmental Insurance Solutions (LEIS) is solely focused on lender environmental insurance and works directly with the commercial lending community. LEIS leads with experience and innovation, and manages and offers the only true lender environmental portfolio insurance product available in the U.S. LEIS environmental insurance professionals have over 40 years combined experience with lender environmental insurance. The portfolio program portal, designed and maintained with an in-house IT team, is fully automated and provides users with efficiency throughout all aspects of their lending activities.