



Commercial Real Estate Loans: Environmental Due Diligence for Lenders

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This Practice Note provides an introduction to the environmental due diligence process regarding commercial real estate loans. Specifically, this Note discusses the importance and scope of environmental due diligence, the role and qualifications of the environmental consultant, the procedures involved in conducting a Phase I and Phase II environmental site assessment (ESA) and the actions necessary following a Phase I or Phase II investigation. This Note also highlights duties and responsibilities for the lender's counsel and borrower's counsel during the environmental due diligence process.

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In a commercial real estate transaction, the parties often perform environmental due diligence to identify any environmental concerns relating to the properties involved in the transaction. The scope of the environmental issues can vary depending on the characteristics of the property and the nature of the transaction, and it is important for each party to identify and understand the unique environmental issues affecting the transaction.

Lenders often require borrowers to conduct environmental due diligence to discover any existing contamination on the property and potential threats of future contamination. This is, in part, because the secured creditor's exemption under the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and similar state laws exempt lenders from liability if the appropriate level of due diligence was conducted (see *Practice Note, Commercial Real Estate Loans: Lender's Environmental Liability* (<http://us.practicallaw.com/3-520-7824>)). Lenders may also review the compliance history or permitting status of a facility to assess the loan collateral and cash flow from a borrower. Due diligence also gives lenders greater comfort that the value of the collateral and the business operations of the buyer will not be impaired by an environmental liability.

This Note provides an introduction to the environmental due diligence process for lenders. Regarding commercial real estate loans, this Note discusses:

- The importance and scope of environmental due diligence.
- The role and qualifications of the environmental consultant.
- The procedures involved in conducting a Phase I and Phase II environmental site assessment (ESA).
- The actions necessary following a Phase I or Phase II investigation.

WHY IS ENVIRONMENTAL DUE DILIGENCE IMPORTANT?

Many properties have environmental issues, and without conducting environmental due diligence, a purchaser and its lenders may unknowingly risk loss of property value or liability for remediation costs. If, for example, contamination from a hazardous substance is found on the property after closing:

- The purchaser generally bears primary responsibility for cleanup costs under CERCLA and similar state laws.
- Any cleanup operation may interfere with the purchaser's business or operations on the property and its stream of income, potentially impairing its ability to repay the loan.
- The property's resale value may decrease, and the purchaser may not be able to repay the loan if forced to sell the property.
- The government may restrict future uses of the property.
- The lender may be jointly and severally liable for cleanup costs if it is unable to gain protection under CERCLA's secured creditor exemption or similar exemptions available under state law (see *Practice Note, Commercial Real Estate Loans: Lender's Environmental Liability: Secured Creditor Exemption and Form of Liability* (<http://us.practicallaw.com/3-520-7824>)).

If properly designed and executed, environmental due diligence allows a party to identify and quantify environmental concerns and, in doing so, make risk-based decisions for a transaction. This, in turn, allows the parties to allocate environmental risk in mutually acceptable ways for the buyer, seller and lender.

Not all commercial transactions require environmental due diligence, and the decision whether to perform due diligence can be guided by several factors, including the type of transaction and a lender's risk tolerance. In general, however, a lender should consider the need for an ESA and other environmental due diligence in connection with any commercial real estate loan. This allows the lender to:

- **Assess any risks involved with using the property as collateral for a loan.** In some circumstances, lenders who are otherwise entitled to foreclose on real property are forced to abandon their collateral when the environmental hazards on the property pose significant risk of liability. Under CERCLA, a lender may in certain instances be considered an owner or operator of contaminated property following a foreclosure action and may be responsible for cleanup costs.
- **Properly evaluate the loan-to-value ratio of the property.** Environmental issues and remedies to cure them can be very expensive and have a substantial affect on the property's value. The purchase price of the property may be based on the buyer accepting responsibility for liabilities or contamination disclosed by environmental due diligence. Therefore, the value of the loan collateral may be reduced if a property is found to be contaminated with hazardous substances. Even suspected contamination can hurt the value of the property, such as when the property is within close proximity of another contaminated site.

Environmental due diligence is also important to lenders because it identifies the presence or threat of any environmentally-related liens encumbering the property. In some jurisdictions, a super-priority lien may exist when a state or federal agency cleans the contamination or hazard on a property and places a lien on the property that the owner or another potentially responsible party (PRP) must repay. Super liens generally have priority over a mortgage lien, which creates significant issues for a lender pursuing a foreclosure action.

Generally, since contamination or hazardous substances on the property can greatly affect the value of the real estate:

- A buyer often includes in its purchase agreement an environmental inspection contingency that allows the buyer to terminate the contract or renegotiate certain terms if the environmental conditions are not acceptable to the buyer.
- A lender may make its loan commitment letter contingent on the environmental findings from the due diligence period being acceptable to the lender.

CONDUCTING ENVIRONMENTAL DUE DILIGENCE

The scope of due diligence needed and steps required for completing it varies on an individual transaction basis. For example, a transaction for real property that was formerly used as a gas station likely requires more detailed environmental due diligence than a transaction for real property that was formerly used for residential purposes. Due diligence can range in complexity from a simple Phase I site inspection to a comprehensive Phase II site investigation including subsurface sampling and environmental risk evaluations.

The Lender's Role

The level of inspection and review needed by the lender on any particular project varies. When a transaction involves a purchase of real property, the lender's interests are generally

aligned with the buyer's interest, and the buyer often engages an environmental consultant to conduct the site inspection and other due diligence activities. Even if the borrower takes the lead on the due diligence process, however, the lender should stay involved in the process to ensure that its requirements are met, including all statutory requirements necessary for the parties to be protected under CERCLA and applicable state laws.

Borrowers who are purchasing the property may look to lenders to guide them in determining the amount of due diligence the borrower must complete. This approach, however, is not advisable for either the lender or the buyer since the scope of a buyer's liability is likely greater than that of a lender and the buyer has greater knowledge of its intended site operations. Therefore, the borrower should tailor its environmental due diligence to satisfy its operational and liability concerns. A lender may consider having a pre-approved list of environmental consultants that the borrower may use.

In connection with the borrower's environmental due diligence, the lender should make its scope and timing requirements clear to the borrower.

The lender should also develop and maintain its own policies and procedures for conducting environmental due diligence. Significantly, lenders should have an appropriate environmental risk assessment and management plan for evaluating transactions. Maintaining its own standards helps the lender ensure that it remains protected from environmental liability.

Designing an Environmental Due Diligence Plan

Before starting the environmental due diligence for a particular real estate transaction, the lender should develop a due diligence plan based on its understanding of the proposed transaction and the buyer's operations. This plan, which should be a guide to assist throughout the process, considers:

- The level of due diligence needed.
- Potential sources of environmental risks.
- Applicable environmental laws, including any property or facility transfer requirements.

The lender should understand the agreement between the buyer and seller regarding site access, sampling, confidentiality and other due diligence activities. If there is no agreement, or if it limits the scope of environmental due diligence too narrowly, the lender should make clear to the buyer that its due diligence requirements must be satisfied before the loan transaction is completed. Furthermore, the structure of the transaction may change during the course of due diligence, and the due diligence plan should be adjusted accordingly. For instance, the transaction may change from a long-term lease to real estate purchase agreement, or environmental indemnities may be negotiated as part of the transaction. Alternatively, additional parcels of real estate or additional facilities may be added to a transaction. In each of these cases, the scope of due diligence should be adjusted accordingly.



Level of Environmental Due Diligence Needed

In determining the necessary level of due diligence in a particular transaction, the parties must balance their need to identify and assess potential issues with their monetary, time or contractual restraints. Factors to consider in determining the level of diligence needed include:

- Characteristics of the real property.
- Nature of the transaction.
- Past uses of the land.
- The buyer's planned use of the land in the future.
- Mitigating factors such as the availability of indemnification or insurance.

ASTM International (formally known as the American Society for Testing and Materials) (ASTM) provides an ESA Transaction Screen Questionnaire, which may be used at the beginning of the due diligence process to determine if a Phase I environmental assessment is needed. The questionnaire is designed to identify potential environmental concerns at a property and may be completed without an environmental professional. The questionnaire, however, assumes familiarity with ASTM materials and the ability to identify evidence of environmental concerns during a property visit. Moreover, completion of the ESA Transaction Screen Questionnaire does not qualify as "all appropriate inquiry" for purposes of statutory liability protection for borrowers or lenders. Accordingly, in a commercial transaction, a Phase I is almost always necessary (see *Phase I*).

Potential Sources of Environmental Risks

The lender should identify potential sources of environmental risks early in the due diligence process. Although new sources of environmental risks may be discovered as due diligence continues, a basic understanding of a property's risks is important at the onset to help determine the scope of diligence needed.

Environmental risks can arise from a variety of sources, including:

- Current and past uses of the property.
- Known contamination on the property or surroundings.
- Compliance with applicable laws and regulations.

The lender should also consider the form of the transaction. There may be different environmental liabilities if the acquisition is in fee title as opposed to a lease or mortgage.

OBTAINING AN ENVIRONMENTAL SITE ASSESSMENT

ESAs are the main component of the environmental due diligence process, and they often assist in determining whether the lender should enter into the transaction from an environmental perspective. An ESA performed by an environmental consultant generally consists of a Phase I assessment, as conducted in accordance with the ASTM standard or the Environmental Protection Agency's (EPA) All Appropriate Inquiry Rule (AAI), and a Phase II assessment (if necessary). As part of each assessment, the environmental consultant generates a report that summarizes its findings and recommendations.

It is important to note that Phase I assessments do not by themselves protect the parties from future exposure to environmental liabilities. Phase I assessments are informational in nature and are one element of obtaining liability protection under CERCLA, but they provide no protection from future liability on their own.

ESA Costs

The borrower usually pays for the ESA. This entails hiring the environmental consultant and paying for any other costs or fees related to the ESA investigation. Generally, the cost of a Phase I assessment may range from a few thousand dollars for a relatively straightforward site, to potentially larger sums as the size or complexity of a site increases.

Phase II costs may vary significantly from site to site, depending on:

- The results of the Phase I.
- The size and complexity of the site.
- The amount of additional investigation and analysis that is needed.

Hiring an Environmental Consultant

An environmental consultant is needed to conduct a proper ESA. To meet AAI requirements for the lender to be protected under CERCLA, the environmental consultant must meet the education, training and experience requirements of an "environmental professional" in Section 312.10(b) in Chapter 40 of the Code of Federal Regulations (see *Environmental Professional Requirements under AAI Rule*). The lender should ensure that the buyer retains a qualified environmental professional in the early stages of the due diligence process. Alternatively, the lender should hire its own environmental consultant meeting these requirements either for its own due diligence activities or for a review of the activities of the buyer's consultant.

The fundamental role of the consultant is to identify and assess potential environmental risks and liabilities affecting the real property and to issue recommendations on whether further investigation or actions are necessary to remedy the potential risks and liabilities. This role involves both a technical understanding of potential environmental risks and the ability to communicate these risks to the client in a meaningful manner. Factors to consider when hiring an environmental consultant include:

- Adherence to the AAI and/or ASTM standards and goals (see *Environmental Professional Requirements under AAI Rule*).
- Availability of qualified and experienced personnel and resources necessary to complete the assessment.
- Liability insurance held by the consultant.
- Availability for lender to review ESA reports before they are finalized. The lender should require a right to review these reports before a consultant recommends a Phase II or other actions that may not be warranted.

The buyer's counsel typically retains the environmental consultant on behalf of the client and serves as the main contact throughout the environmental due diligence process. This arrangement may allow the parties to keep confidential certain information relating to the property and the contemplated transaction. Sometimes this arrangement may also protect communications between counsel and the environmental consultant under the attorney client privilege.

Consultant's Experience

The lender must be sure that the consultant retained by the buyer has the necessary education and experience to qualify as an "environmental professional" under the AAI rule. Experience requirements for the environmental consultant can vary based on:

- The nature of the property.
- The anticipated future use of the property.

The consultant should have experience developing a comprehensive risk profile based on all of the factors within the scope of the ESA, local and state law, and the client's business needs. If the buyer is aware of any specific environmental conditions or concerns on the property at the time the environmental consultant is retained, the consultant's experience with these conditions often is a significant factor in the buyer's consultant selection (see *Environmental Professional Requirements under AAI Rule*).

Lender's Recourse against Consultant

Both buyers and lenders face significant financial consequences if there is a problem with the consultant's work. Failure to discover environmental conditions threatening or affecting the property may impair the buyer's ability to repay the loan and the value of the lender's collateral. Further, the parties may be limited in their recourse against the environmental consultant by:

- The terms and conditions contained in the agreement between the parties.
- Contractual limitations of liability in the agreement with the consultant.
- The consultant's financial condition at the time of the claim.

Previously Conducted ESAs

Sometimes a Phase I report for the property may already exist. This could occur if the current owner conducted a Phase I when it purchased the property, or if the owner wanted to investigate the environmental condition of the site during its period of ownership. While the availability of an existing Phase I may be helpful, a lender should not necessarily rely on the analysis of a pre-existing report regarding the risks and liabilities for a particular site or project. Instead, the borrower or lender should retain an environmental consultant to conduct a new evaluation that may consider the existing Phase I report to the extent appropriate.

If a prior Phase I exists and is to be relied on for liability protection, the lender must ensure that the existing Phase I

is current and in compliance with the AAI or ASTM standards (see *Phase I Standards*). In general, the Phase I must be completed within one year before the loan closing date. More specifically:

- Certain activities must be conducted or updated within 180 days before acquiring the property, including:
 - the site visit;
 - interviews; and
 - government record reviews.
- Information research must be conducted or updated within one year before acquiring the property.

If an ESA expired or certain activities were conducted before the time permitted by the Phase I standards, the lender will not have liability protection under CERCLA if it relies solely on the stale ESA (see *Phase I Standards*). Therefore, a new ESA or a thorough review of a past ESA should be completed specifically for the present real estate transaction. In addition, the lender must obtain a reliance letter from the environmental consultant that prepared the pre-existing Phase I authorizing the lender to rely on the consultant's report.

PHASE I

After creating an environmental due diligence plan and hiring an environmental consultant, the Phase I is generally the next step in the environmental due diligence process. The purpose of the Phase I is to:

- Identify recognized environmental conditions (REC) that may affect the property or impose liability on the parties and determine whether these conditions require further investigation.
- Obtain environmental information useful to negotiate the price of the property, the terms of the transaction and the amount of the loan.

If the Phase I does not reveal any RECs, there may not be any need for further due diligence.

Phase I Standards

To gain the protections of the lender liability exemption under CERCLA, the Phase I assessment must be conducted with "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice," as specified in section 9601(35)(B) in Chapter 42 of the US Code. The standards currently used for completing the Phase I investigations are:

- The ASTM E 1527-05 Standard (see *ASTM 2013 Update*).
- The EPA's AAI Rule.

Although compliance with either standard satisfies the CERCLA requirements, the parties should consult applicable state laws to determine the existence of state law standards and whether additional requirements are applicable.



A report using either the ASTM or AAI method is designed to identify RECs. The ASTM defines RECs as “the presence or likely presence of any hazardous substances or petroleum products on a property under conditions that indicate an existing release, a past release, or a material threat of a release of any hazardous substances or petroleum products into structures on the property or into the ground, ground water or surface water of the property.”

Many ASTM Phase I reports also include business environmental risks (BER), which are potential environmental issues that do not involve the release of hazardous substances but can still pose a threat to a lender or a borrower (see *Business Environmental Risks (Extended Phase I)*). Significantly, compliance with the ASTM or AAI standards only protects lenders and buyers from response or remediation costs under CERCLA (or similar state laws), not from potential exposure under regulatory statutes such as the Clean Water Act, the Resource Conservation and Recovery Act (RCRA) or other federal and state environmental statutes.

ASTM 2013 Update

ASTM E 1527-05 will be reissued in 2013 under ASTM rules that require its standards to be discontinued or reissued every eight years. Several changes being considered for the reissued standard include:

- Revising the definition of REC to exclude a release inside a building, to be consistent with the CERCLA definition of release.
- Adding the term “Controlled REC” for closed RECs that are managed under a land use restriction or covenant.
- Greater regulatory file review discussion.
- Language explicitly stating that the vapor intrusion pathway must be considered.

Lenders should be aware of any changes to the ASTM standard and review their due diligence plan in light of any changes.

Environmental Professional Requirements under AAI Rule

The lender must ensure that the Phase I is conducted by professionals who meet the EPA's strict AAI rule standards for a combination of experience, education and certification.

A person who qualifies as an environmental professional must currently have one of the following:

- Ten years of full-time, relevant experience.
- A professional engineer's or geologist's license or registration from a state and three years of experience.
- At least a bachelor's degree from an accredited school in a discipline of engineering or science and five years experience.
- A license or certification by federal or state government to perform environmental inquiries and three years of experience.

Time Limits

In general, the research and investigation portion of the Phase I

must be conducted or updated within one year before the loan closing date. If the Phase I is dated more than one year before closing, the report must be updated or redone.

Certain activities, such as the site visit, interviews and government record reviews, are valid for only 180 days. If the time period for any of these items expires before the loan closes, each expired item must be updated.

Scope of a Phase I Assessment

The scope of a Phase I investigation varies for every real property transaction. However, every Phase I report under the ASTM standard addresses the following five general assessment areas:

- Historical site information (see *Historical Site Information*).
- A site visit (see *Site Visit*).
- Personal interviews (see *Interviews*).
- Database radius searches (see *Database Radius Searches*).
- Local agency inquiries (see *Local Agency Inquiries*).

Historical Site Information

Every Phase I requires a historical site search to develop a history of the uses of the property and the surrounding area. Knowledge of any prior use of the property and surrounding area provides insight as to whether the property is presently contaminated or is at risk of future contamination. Under the AAI standard, the historical research, as reasonably ascertainable, must go back to either:

- As far as it can be shown that the property contained structures.
- When the property was first used for residential, agricultural, commercial, industrial or government purposes.
- 1940.

When investigating a property's historical information, the environmental consultant generally reviews the following standard historical sources:

- Fire insurance maps.
- Aerial photographs.
- City directories.
- Zoning and land use records.

Additionally, to determine prior owners and past uses of the property, the environmental consultant generally reviews the recorded land title records. Under the ASTM standard, the environmental consultant is not responsible for reviewing land records for environmental liens or activity and use limitations, but may do so if included in its scope of work and provided in the title search.

The lender's counsel and borrower's counsel should ensure that the environmental consultant completes a thorough historical site search in compliance with the ASTM or AAI standards.

Site Visit

A site visit is a required element of the Phase I assessment. In addition to observing the current use of the property and looking for visual clues of any potentially hazardous conditions, visiting the property can also provide insight into past uses of the property.

One of the main purposes of the site visit is to look for activities that may give rise to future liabilities. For example, old structures on the property could indicate a potential problem with lead paint or asbestos contamination. The consultant performing the visual inspection should:

- Inspect the property for any noticeable RECs.
- Look for clues into current and past operations, including the presence of:
 - drums;
 - tanks;
 - odors;
 - waste piles;
 - stressed vegetation;
 - corrosion;
 - debris; and
 - pools of slime or sludge.
- Inspect the general condition and state of the housekeeping of the site.
- Make interior and exterior observations of any structures on the property.
- Observe surrounding properties to determine if they are industrial or residential, and if they are likely to indicate RECs.

During the site visit, the environmental professional should also determine water access to the property, including whether the property has access to public water and sewer resources or whether ground water is necessary for drinking supplies. Additionally, the environmental professional should inspect any engineering and institutional controls.

Interviews

Conducting personal interviews of present and past owners, operators and occupants of the property is another important part of the Phase I. These interviews can occur during the site visit or at any time throughout the due diligence process, and they may include:

- Key site managers (before site visit).
- Current tenants or occupants.
- Past tenants or occupants.

The consultant can use the interview as a way to collect or request documents from involved parties. Many of the documents needed in the Phase I process are public and can be obtained through public sources (see *Historical Site Information*). However, some documents are private and can only be obtained directly from the seller or current tenant, including:

- Maps or plans of the facility's piping or piping diagrams.
- Information or maps about any USTs.
- Information or maps on any prior waste disposal areas.
- Copies of existing environmentally related permits.
- Environmentally related citations or consent orders.
- If it is an operation currently dealing with hazardous waste:
 - manifests;
 - annual permit fee invoices; and
 - generator reports to the EPA or the state's environmental agency.
- Any existing environmental audits, studies, boring logs or other engineering information.
- Material safety data sheets of raw materials and products utilized on the property.
- Asbestos test results.
- On-site electrical transformer tests for PCB content.

Database Radius Searches

A thorough database radius search identifies potential risks of contamination on the property by searching for problems in surrounding areas of the property. Contamination in surrounding areas of the property can place the property at risk for migrating contamination or hurt its value simply by proximity.

Under the ASTM standards, the minimum radial distance within which the consultant must search depends on many factors, including the type of potential hazard at surrounding properties. For example, the ASTM standard suggests an approximate search distance for leaking USTs of within a half mile radius of the property, and for any properties on the superfund national priority list of within one mile of the property. These distances are subject to the discretion of the consultant and for a complete list of potential sources and distances, see the ASTM *website*.

The lender should ensure that the consultant uses database reports from a reputable national provider.

Local Agency Inquiries

A detailed Phase I investigation includes local agency (and Indian tribe) searches to find information that may not be found in a national database and indicates RECs in connection with the property. For example, a local fire department may be aware of a UST located nearby, even if the UST is not recorded on the national database.

Public database searches may not identify recently installed USTs or other potential contamination risks if they have yet to be updated. A reasonable attempt should be made during the Phase I assessment to interview an individual at:

- The local fire department that serves the property.
- The local or regional office of the state health agency.
- The local or regional office with jurisdiction over hazardous waste disposal or other environmental matters where the real property is located.



Business Environmental Risks (Extended Phase I)

Some properties may warrant additional research, under the category of an “extended Phase I.” This type of assessment includes potential risks that are outside the scope of the Phase I standard. Significantly, the Phase I standard does not generally include assessments of the following potential conditions:

- Compliance with activity and use limitations.
- Asbestos-containing materials.
- Radon.
- Lead-based paint.
- Lead in drinking water.
- Wetlands.
- Regulatory compliance.
- Cultural and historic resources.
- Industrial hygiene.
- Health and safety.
- Ecological resources.
- Endangered species.
- Indoor air quality.
- Biological agents.
- Mold.

In addition, a regulatory compliance assessment may include:

- Proper permitting.
- Compliance issues, including reporting and monitoring requirements.
- Storage and transport of hazardous wastes (if applicable to the site).
- Legality of methods currently used for off-site disposal of hazardous substances.

Lenders should appreciate that these potential environmental risks are not part of a standard Phase I assessment, and determine whether a particular transaction requires assessment of one or more of these considerations based on its risk profile and site concerns. Consideration of these potential environmental risks may require site sampling or testing.

Phase I Results Presentation

Phase I results must be presented in a written report. The AAI rule sets specific requirements for reporting the findings of the environmental professional in its Phase I investigation (40 C.F.R. § 312.31). The Phase I report does not have any specific format, length or structure requirements, but the standards identify specific information that the environmental professional must include in the written report.

These requirements include:

- An opinion stating whether the investigation has identified any threats of contamination or hazardous release.

- An explanation of any gaps in data and whether these gaps have any effect on the environmental professional’s ability to identify hazardous conditions.
- An opinion regarding additional, appropriate investigation, including recommendations for further inquiry, if necessary.
- The qualifications and signature of the environmental professional. The AAI rule requires specific statutory language to accompany the signature.

A thorough and detailed Phase I report often includes information in addition to that required by CERCLA, and each area of required investigation should be included (see *Scope of a Phase I Assessment*). The EPA provides a *fact sheet* with suggestions on what to include in a Phase I in addition to the statutory requirements.

In addition to the required sections, other topics to address in the Phase I report, as recommended by EPA’s guidance, include:

- A site description containing basic information about the property and its surrounding area. This can include site geology, nearby roads, available utilities and current and historic uses of the property.
- A record review summarizing the information found in the records by the consultant when conducting the historical search and database radius search.
- Site reconnaissance providing a brief analysis from the site visit. This can include the findings from the visit, the methodology used in conducting the reconnaissance and the identity of the individuals who performed the reconnaissance.
- Interview results summarizing the results of the interviews (see *Interviews*). Also included in this section (or in its own section) is information that the consultant obtained from the lender or buyer, including:
 - title records;
 - commonly known or reasonably ascertainable information;
 - specialized knowledge or experience; and
 - a comparison between the purchase price and the estimated fair market value.
- Overall findings summarizing any discoveries made during the investigation. This section can include information from any of the aspects of the Phase I, including:
 - historical research;
 - database radius searches; or
 - information found while visiting the site.
- Conclusions summarizing all hazardous conditions or potential contamination risks connected with the property.
- Additional services summarizing any additional information outside the scope of a traditional Phase I investigation that is specifically requested by the lender or the purchaser (see *Business Environmental Risks (Extended Phase I)*). If the parties agreed to allow the environmental consultant to conduct additional research, these findings can be included in their own section.
- References listing any published resources used during the Phase I investigation.

- Appendices listing all important documents, maps, photographs or other relevant material.

Phase I Results Interpretation

After the environmental professional completes the necessary Phase I investigations, the borrower, lender or both will determine if a Phase II investigation is necessary in consultation with the environmental professional. The need to conduct environmental due diligence beyond a Phase I varies depending on the nature of the property and the findings of the Phase I.

After the Phase I is completed, most properties fall into one of the following general categories:

- **The property is perceived to be clean.** If no environmental risk is detected, no further investigation is needed, and the lenders may issue the loan.
- **An environmental exposure had existed, but no further action is required.** The property had a contamination or risk that used to exist but is now remediated or has otherwise been addressed. Sometimes additional environmental due diligence is needed to ensure the problem will not return, but usually in this case it is safe for the lender to close the loan transaction.
- **There is a REC.** When the Phase I finds an environmental condition or hazard, further testing of soil or groundwater is recommended. A lender should wait until a Phase II investigation is completed before closing the loan transaction (see *Phase II*).

Lenders should carefully review the Phase I results with the environmental consultant before deciding to:

- Close the loan transaction.
- Conduct additional environmental due diligence.
- Terminate negotiations with the borrower.

PHASE II

Where necessary, the next step in the environmental due diligence process for a commercial loan transaction is a Phase II assessment. A Phase II usually involves sampling and testing of soil, air, surface water and/or groundwater. The Phase II assessment is used to further investigate the results of a Phase I.

Unlike a Phase I, which is required for every transaction where the lender seeks liability protection under CERCLA, a Phase II is only required if warranted by the Phase I findings and other available information.

When a Phase II is Needed

Generally, a Phase II is needed when the Phase I identifies a REC or area of concern and the environmental consultant recommends additional investigation. Properties affected by certain environmental conditions will always require a Phase II, and, if the condition is known at the outset, the Phase I and Phase II investigations may be combined to expedite review. For example, a Phase II is generally recommended when the property:

- Is a manufacturing facility containing wastewater treatment facilities and hazardous waste disposal facilities.
- Is an old gas station with original USTs.
- Is agricultural in nature with a former or existing shed used for making pesticides.
- May contain friable asbestos.
- Contains USTs without proper operation documentation or close-out reports.
- Is a known hazardous waste site according to EPA's RCRA and CERCLA programs.

Scope of a Phase II Assessment

If a Phase II is needed, the borrower and lender must determine what the Phase II should entail and, if necessary under the relevant agreements, obtain the seller's approval to proceed. Before conducting any testing or sampling on the property, the parties should agree on possible legal issues based on the potential findings of the Phase II, including any reporting requirements if contamination is found. Many sellers prefer that any Phase II investigation and analysis be done confidentially between the parties so that the seller has an opportunity to proactively address any environmental problem that may be identified.

From the lender's perspective, the Phase II should focus on environmental issues that would affect the borrower's ability to repay the loan. The scope of a Phase II varies based on the results of the Phase I, and if the Phase I identifies a variety of potential contamination threats, a more thorough Phase II may be needed. However, sometimes a Phase II may be limited to:

- Additional regulatory review.
- Integrity testing on a UST.
- A soil sample.

Conducting the Phase II

The Phase II investigation usually consists of any necessary site sampling and chemical analysis. The process usually involves testing air, soil or water samples for their levels of contamination or pollution.

For example, a common problem that often requires a Phase II investigation is the presence of USTs. A release from a UST can cause numerous problems for a site, so before agreeing to close the loan transaction, the lender should ensure that the environmental consultant thoroughly evaluates the following issues:

- Compliance with current regulatory standards regarding design, construction, operation, recordkeeping and reporting.
- Monitoring of potential leaks to comply with current regulatory standards.
- The availability of state clean up funding if needed.
- Financial responsibility requirements for owners of USTs.

Phase II Results Presentation and Interpretation

Phase II results can be presented in various ways. However, they are usually done in the form of a report that presents all information related to the Phase II investigation. For example, most Phase II reports include the following sections:

- **Executive summary.** The executive summary is a brief explanation of the report to follow, which generally contains the objective of the Phase II and an overview of the testing procedures and results.
- **Introduction.** The introduction includes background information, the planned scope of work, methods and objectives used to complete the work, and basic site information such as its history, land use and adjacent land use.
- **Phase II activities.** This section contains a description of field program rationale, plans for specific tests and identification of the substances to be tested such as chemicals, soils and groundwater.
- **Results of testing.** This section contains the results of each test identified in the prior section.
- **Discussion and conclusions.** This section contains an analysis or discussion of the findings from the Phase II testing and contains recommendations for any necessary environmental remediation.
- **Limitations.** This section contains an explanation of any complication that may have limited the testing procedure.

The Phase II is used to determine if any remediation is necessary. Based on the results of the investigation, the buyer or the lender may decide to terminate the transaction, but the presence of contamination or the need for remediation does not always terminate a deal. Instead, the parties may renegotiate the purchase price, or the seller may agree to perform the remediation before the transaction closes.

POST-DUE DILIGENCE ACTIONS

After the Phase I and Phase II investigations, the buyer or seller may be required to take remedial action for any contaminations or other environmental problems discovered at the property. Whether remediation is necessary depends on the nature of the property and the extent of environmental damage.

Examples of remedial actions include:

- Removal of contaminated soil, asbestos or spill residues.
- Cleanup of contaminated surface water or groundwater.
- Abatement of certain industrial operations that contribute to air emission problems.
- UST removal, replacement or both.
- In-place treatment of contaminated soil.

Any action to remedy an environmental contamination or hazardous waste requires a detailed work plan subject to regulatory approval.

If the parties decide to proceed with the transaction, the buyer can obtain protections from the seller in many ways, including:

- Representations and warranties in the purchase agreement.
- Indemnification agreements from the seller to the buyer that survive the closing.
- Adjustments in purchase price.

The lender may also obtain protections from the borrower through:

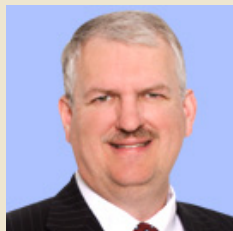
- Environmental indemnity agreements from the borrower and the borrower's guarantors.
- Environmental representations and warranties from the borrower in the loan agreement.
- Ongoing environmental covenants in the loan agreement from the borrower.

If the parties elect to continue the transaction after the environmental due diligence is completed, the borrower and the lender should evaluate whether they have any self-reporting obligations to EPA or any state environmental agency. In general, the self-reporting audit policies of EPA and many states provide penalty reductions to a buyer that voluntarily discloses violations discovered during due diligence or an audit. For ongoing manufacturing and industrial facilities, these audit programs may be beneficial to new ownership assessing the operations and integrating its business culture and practices.

Even if no remedial action is required at the property, the new owner may have continuing obligations under CERCLA after purchasing the land to maintain the liability protection. These obligations begin the day the owner takes title to the property and include taking reasonable steps to stop or prevent continuing or threatened future releases and exposures. (See *Practice Note, Commercial Real Estate Loans: Lender's Environmental Liability: Maintaining the Defenses Post-closing* (<http://us.practicallaw.com/3-520-7824>).)

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For more information, search for the following resources on our website.

Topics

- Environmental
(<http://us.practicallaw.com/topic3-500-0079>)
- Real Estate
(<http://us.practicallaw.com/topic4-500-0074>)
- Real Estate Finance and Investment
(<http://us.practicallaw.com/topic9-103-2086>)

Practice Note: Overview

- Commercial Real Estate Loans: Overview
(<http://us.practicallaw.com/6-508-8754>)

Practice Notes

- Commercial Real Estate Loans: Closings
(<http://us.practicallaw.com/6-513-3412>)
- Commercial Real Estate Loans: Due Diligence
(<http://us.practicallaw.com/8-513-3350>)
- Commercial Real Estate Loans: Lender's Environmental Liability
(<http://us.practicallaw.com/3-520-7824>)
- Commercial Real Estate Loans: Minimizing the Environmental Risk for Lenders under CERCLA
(<http://us.practicallaw.com/9-525-7439>)
- Commercial Real Estate Loans: Workouts
(<http://us.practicallaw.com/7-505-9925>)
- What's Market: Credit Agreements in the Oil & Gas Industry
(<http://us.practicallaw.com/9-525-1178>)

Standard Documents

- Commercial Real Estate Loans: Loan Closing Checklist
(<http://us.practicallaw.com/0-509-0849>)
- Commercial Real Estate Loans: Pre-negotiation Letter
(<http://us.practicallaw.com/4-507-0496>)
- Landlord Lien Waiver and Collateral Access Agreement
(<http://us.practicallaw.com/0-519-3201>)

For the links to the documents referenced in this note, please visit our online version at <http://us.practicallaw.com/3-525-2072>

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