COMPONENTS OF ENVIRONMENTAL DUE DILIGENCE INVESTIGATIONS

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Environmental due diligence investigations have become an essential tool for lenders in the marketing and managing of commerical loans. These examinations may be used not only to evaluate whether a heavily-leveraged borrower may be required to fund a cleanup that could render it insolvent but also enable lenders to screen or exclude properties from the transaction or to identify properties that can be foreclosed. Finally, the investigation allows lenders to preserve various defences that may be available to them under federal and state environmental laws.

Under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) a lender may become strictly liable for the cleanup costs of its borrower or contamination that predates its borrower if the lender becomes overly entangled in the day-to-day operations of the borrower or forecloses on the property. Because of the harsh impact this law has had on innocent landowners and financial institutions, Congress crafted an "innocent purchasers" defence which could insulate lenders from liability if they used "appropriate inquiry into the previous ownership and uses of the property consistent with good commerical or customary practice" prior to booking the loan or foreclosing on the property.[1] In determining whether "all appropriate inquiry" was made, a court is required to examine "any specialized knowledge or experience on the part of the defendant, the relationship of the purchase price to the value of the property in an uncontaminated state, commonly known or reasonably ascertainable information about the property, the obviousness of the presence or likely presence of contamination at the property, and the ability to detect such contamination by appropriate inspection."[2]

CERCLA does not precisely describe what constitutes an "appropriate inquiry" so courts will determine if a lender conducted an appropriate investigation on a case-by-case basis. It is clear, though, that if an undeveloped parcel is sold for a price well below the market value of comparable parcels, a lender taking a security interest in the land should inquire about the environmental condition of the property. Likewise, metal drums or distressed vegetation might be deemed to be signs of the "likely presence of contamination" and failure to conduct a walking tour of the site might preclude a lender from asserting the innocent purchaser's defense.

OTHER FEDERAL DUE DILIGENCE REQUIREMENTS

The federal National Mortgage Association (Fannie Mae) has established environmental due diligence requirements for the secondary mortgage market and the Federal Home Loan Bank Board (FHLBB) has issued guidelines for the development of environmental risk policies for thrift organizations.[3] In addition, the federal Home Loan Mortgage Corporation (Freddie Mae) has circulated proposed rules for lenders whose mortgages they purchase. These requirements only pertain to residential properties but because of the lack of federal due diligence standards, lenders have tended to adopt the environmental auditing requirements set forth by Fannie Mae and FHLBB.

Under the Fannie Mae underwriting requirements for multi-family properties, environmental audits are divided into two phases. The Phase I audit requires lenders to review easily accessible information about the site and properties located witin a one-mile radius. Lenders must check federal and state environmental data bases for the subject property and all sites within a one-mile radius of the property. The lenders are also required to conduct a site inspection of the property, there must not be visible signs of friable asbestos or ureaformaldehyde insulation, and there must not be concentrations of hazardous substances that exceed state or federal guidelines. Lenders must also confirm in writing from time to time that the borrower is maintaining the property in accordance with environmental laws. The Phase II audit includes more extensive investigation including sampling. Fannie Mae may decline to purchase a loan if a structure is built over a landfill, there are concentrations of hazardous substances above state or federally-established levels or corrective action cannot be taken because of physical constraints or financial inability of the borrower.

The Fannie Mae requirements for single homes places the burden for reporting environmental problems on real estate appraisers who must consider environmental conditions of "common knowledge" when determining market value which probably means all information contained in public records.

Identification of environmental problems is also important for compliance with the United States Security and Exchange Commission (SEC) reporting requirements for environmentally-related matters. The SEC regulations require reporting of any administrative or judicial proceedings commenced or that the company knows is contemplated pursuant to authority under federal, state or local environmental laws if the governmental proceeding will materially affect the business or financial condition of the corporation; if the damages, sanctions, or likely capital expenditures needed for compliance will exceed ten per cent of the current assets of the corporation, or if the monetary sanctions are likely to exceed $100,000.[4] Failure to comply with these requirements may not only result in the initiation of SEC enforcement proceedings but may also subject the corporation to shareholders' class actions and derivative suits. Indeed, a stockholder of the Denver-based Western Capital Investment Corporation recently filed a class action suit charging that the savings and loan company's stock was artificially inflated because it had deliberately failed to disclose on its balance sheet asbestos abatement costs of buildings it owned through foreclosure.

It is strongly advisable to conduct environmental due diligence examinations on each parcel that will be part of the

transaction. However, because of cost considerations or time constraints, it is not uncommon in multi-parcel transactions for the parties to restrict site assessments to a limited number of properties. These sites selected are usually those likely to have the worst problems, that have operations within certain SIC numbers or that represent the most valuable properties. For example, on a multi-million transaction, sites with $10,000 of liability may be ignored but several of those sites could pose severe problems for a one million deal.

It is important that lenders do not succumb to competitive pressures and accept inadequate audits because faulty audits may prevent them from invoking the innocent purchaser's defense. This was demonstrated in *In BCW Associates Ltd. v Occidental Chemical Corp.*[5] where the purchaser of a warehouse unsuccessfully raised the innocent purchaser's defense and was found liable for response costs to remove lead-contaminated dust even though it received an unqualified opinion that there were no hazardous substances at the property. The court found that the plaintiff had failed to exercise due care because the report had identified a possible area of environmental concern but declined to further investigate because of the expense of additional testing. The court seemed to be persuaded that the discounted purchase price of the warehouse and the fact that the purchaser was aware it was buying an old, industrial warehouse should have put the purchaser on notice that a more extensive investigation was warranted.

The most cost-effective environmental due diligence investigation is a three-phased approach. Under this methodology, the information obtained in the preceding stage influences the scope of the succeeding phase.

PHASE I ENVIRONMENTAL AUDITS

The Phase I Environmental Risk Assessment is commonly referred to as a preliminary environmental site assessment by environmental consultants. It generally includes preparation of a highly technical questionnaire which is to be completed by an engineer or plant manager of the facility. The questionnaire will seek to identify areas for further investigation and will also be relied on by counsel to prepare an environmental opinion.

This preliminary environmental assessment will also include a review of public and private records to ascertain the present and past regulatory and operational history of the site. This inquiry can be performed by the lender's environmental risk analyst or environmental counsel.

The Phase I environmental assessment should be performed on any of the following types of properties that a purchasing is contemplating acquiring or that a lender is considering relying on as collateral:

- Industrial properties including iron and steel, petrochemical, pharmecutical, plastics, paper, glass, mining, metal finishing, electroplating, food processing or canning establishments as well as properties adjacent to industrial complexes;
- commercial properties which contained or were close to gasoline service stations, automotive repair shops, dry cleaning establishments, photographic developers, paint operations, hospitals or medical buildings, jewellers;
- high-tech and electronic companies such as printed circuit boards and computer component manufacturers who may use solvents, acids and other materials regulated as hazardous substances;
- properties located next to railroad tracks or pipelines;
- farm and ranch lands where toxic substances such as pesticides, herbicides and fertilizers may have been applied;
- sites that were used as or are adjacent to landfills, old town dumps and waste disposal;
- buildings or properties that may contain asbestos;
- buildings located in regions known to have emission of radon gas;
- multi-family or single-family residential properties located within a one-mile radius of a superfund site;
- shopping malls, restaurants and proposed construction projects which may either contain underground storage tanks or may have contamination from prior uses.

Title Search

Records should be reviewed to reconstruct the chain of title as far back as possible to determine if the property was previously used for on-site generation, storage or disposal of hazardous materials. This information can be obtained from title abstracts, tax records, subdivision maps, building or land use permits and interviews with local officials. However, if the owner was not the operator of the site, this review may not reveal prior operating history or uses of the site.

Facility Records Review

Valuable historical information can be obtained from the seller or borrower including site plans, engineering surveys, blueprints and aerial photographs which locate structures, underground storage tanks, PCB transformers or capacitors, floor drains, sewer lines, lagoons, settling ponds, trenches, railroad tracks, areas of hazardous waste storage and the presence of asbestos.

Regulatory Compliance Records

Businesses subject to environmental regulation are required to maintain a variety of records on the site and are obligated to file reports with the state and regional office of the EPA including reports of spills, notifications that certain hazardous substances are present at a plant and registration of underground storage tanks.

Neighboring Properties

Because nearby properties can be a source of contamination and can drastically affect the value of mortgaged properties, the uses of property within a one-mile radius should be reviewed. There are several state and federal data bases such as CERCLIS, SEC filings, and ATSDR registry of sites which may be consulted.

PHASE II ENVIRONMENTAL AUDITS

The Phase II site inspection involves a tour of all on-site facilities to determine if there are areas of potential environmental concern that might need to be further investigated. In multi-parcel transactions, the parties may elect to prioritize their resources and only visit a portion of the sites based on the results of the information obtained from the other data-gathering techniques. The site inspection should be be performed by an environmental consultant although a representative of the lender should accompany the consultant to become famil-

iar with the operation. During the tour of the plant, the following areas should be reviewed:

Floors and Walls

In manufacturing and processing operations and any machinery using hydraulic fluids or solvents check for staining, cracking or deterioration which may indicate spillage or careless handling of hazardous materials. The location and condition of floor drains, sink drains, floors, exposed pipes, and sumps, should be noted and compared against the blueprints since these can serve as collection or discharge points for hazardous materials. It is also important to determine where the conduits drain.

Air Emission Sources

These include fossil fuel burning equipment and incinerators, and the pollutants that are emitted. Ducts and ventilation equipment should be inspected for signs of improper emissions as well as air pollution control equipment to determine compliance with the air pollution permits. Not only must the cost of installing new pollution control equipment be evaluated as well as any fines or penalties for non-compliance but also the costs of the air quality impact and health assessment studies that will be necessary in the event additional equipment or permits are required.

Wastewater Treatment

Facilities generally discharge wastewater into municipal treatment plants although some may still discharge into non-contact heating or cooling waters into local waterways. The wastewater treatment facilities and outfalls should be inspected and compliance with permit effluent limitations as well as any local pretreatment requirements.

Stormwater Runoff

Discharge and collection points for the stormwater sewers should be located and determine if the stormwater runoff is discharged into the municipal sewer system, to a wetland, into a subsurface disposal system or into a surface water or if it comes into contact with process or wastewater prior to discharge. The collection points spill control or containment structures should be inspected to see if contaminants are mixing with the stormwater. If the stormwater conduits discharges into surface water, it is also important to determine if that stream will be subject to the individual control strategy (ICS) program which will require the stormwater discharge to obtain a permit.

Surface and Groundwater Quality

Locate and note the appearance of all bodies of water on the property including ponds, streams, lakes swamps, creeks and wetlands, discharge sources into those waterbodies and identify drinking water sources such as wells. Also ascertain if groundwater monitoring wells are present and review results of any prior sampling analysis.

Asbestos

Examine boiler rooms, ceilings and steel beams for the presence of friable asbestos.

PCBs

Determine if transformers or capacitors contain PCBs and verify compliance with applicable federal and state PCB regulations.

Raw material Storage Areas

These should be inspected and the condition and contents of drums, barrels, cans should also be verified. Unlabelled, deteriorating or open hazardous waste containers may not only indicate poor housekeeping but also may possibly be signs of non-compliance with state and federal environmental, safety and health regulations and codes.

Waste Storage/Treatment/Disposal

Improper waste storage disposal may lead to extensive groundwater and soil contamination requiring expensive remediation. Costs may also be incurred to upgrade inadequate storage areas to meet design standards such as impervious lining and diking. Accordingly, locate and examine the condition of the waste management facilities such as lagoons, impoundments, holding ponds, tanks and drum storage areas noting signs of spillage from overloading or leakage from poor construction. Also look for discoloured soil, stretches of bare soil, or dead or distressed vegetation which may be the site of former waste storage units.

Underground Storage Tanks (UST)

Leaking underground storage tanks can also be a major source of soil and groundwater contamination. The location of all buried tanks, age, construction and contents should be ascertained and put particular attention to caps of fillpipes which may indicate the presence of abandoned UST. Determine if the UST have been registered and if they must be upgraded to meet state or federal design standards.

Fuel Storage and Vehicle Maintenance Areas

Spillage from fuel transfers or poor waste oil management can lead to soil and groundwater contamination. Look for signs of staining or deterioration of pavement or concrete and determine the purpose and discharge point of all drains located in these areas. If there is an oil/water separator, ascertain capacity, age, construction and review permits and any inspection reports since malfunctioning oil/water separators will often result in surface water or soil contamination.

Loading Docks, Shipping Areas and Railroad Sidings

Spills of hazardous materials commonly occur in these areas when raw materials or products are transferred.

Because many sources of contamination cannot be visually observed, a financial institution might consider authorizing the use of metal detectors to identify buried metal structures such as storage tanks as well as a volatile organics analyzer which can "sniff" gases evaporating through the soil from buried storage facilities or plumes of contamination.

Upon the conclusion of the Phase II investigation which typically takes about three weeks and may cost between $2,000-$10,000, the environmental consultant should prepare a report to the lender summarizing the results of the investigation and indicating those areas of environmental concern that may require additional investigation.

PHASE III ENVIRONMENTAL AUDITS

The prior examinations are usually sufficient for commercial, light industrial and small parcel acquisitions. However, when heavy industrial properties are involved or if the previous investigations flags areas of potential environmental concern, more extensive investigation involving soil sampling, groundwater and surface water monitoring or stack emission sampling may be required. Delineating the extent of soil and groundwater contamination can be extremely costly especially for transactions in the $1-$10 million range which is the heart of the business of many financial institutions and this expense may kill otherwise viable deals.

Generally, the Phase III investigation will include testing of

underground storage tanks, soil gas analysis to identify the presence of volatile organic compounds or petroleum hydrocarbons, groundwater and surface water sampling, analysis of local geologic and hydrogeologic conditions, list of individual groundwater samples followed by groundwater monitoring wells if groundwater contamination is indicated as well as samples from within buildings suspected of having asbestos.

A final environmental assessment report must be prepared upon the inclusion of the Phase III investigation which may take several months to complete and can cost between $30,000-$60,000 per site depending on the size and type of operations. A draft of this report should be reviewed by counsel. The report should be forwarded directly to lender to establish that it conducted a due diligence investigation. □

* This article is extracted from the author's forthcoming book, "Understanding Environmental Law: A Practical Guide to Managing and Allocating Environmental Liabilities" to be published in 1990 by Butterworth Legal Publishers, USA.

1 42 U.S.C. 9601(35)
2 42 U.S.C. 9601(35)(B)
3 Environmental Hazards Management Procedures (August 1, 1988); Environmental Risk and Liability (February 6, 1989)[Thrift Bulletin 16].
4 17 C.F.R. 229.103(5)(A)-(C)
5 No. 86-5947 (E.D. Pa. September 30, 1988).