Foreclosures can carry costly environmental baggage

By DANIEL JOHNSON, SCS Engineers
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A financial institution recently foreclosed on a commercial property only to learn that the Environmental Protection Agency had initiated an action to make the owners of the site a "potentially responsible party" in a Superfund groundwater cleanup action. Although the property had no current environmental issues, the EPA had issue with the property due to the historical uses of the property as a plating facility. This ultimately cost the bank several million dollars.

This outcome could have been averted through simple due diligence. Had the bank ordered a fully compliant "all appropriate inquiry" (AAI) Phase I environmental site assessment or some form of environmental due diligence, the issue would have been discovered prior to foreclosure. The bank could have evaluated the potential risks and liabilities and taken the appropriate actions to protect itself before deciding to foreclose on the property.

Unfortunately, this is an all too common scenario in this era of financial meltdown and distressed assets. Most banks now have Real Estate Owned, or REO, departments and "workout" managers to handle the mounting number of foreclosures on commercial properties -- something we have not seen since the early 1990s. Yet, lenders foreclosing on distressed assets, and buyers looking to make a quick buck from them, too often underestimate or ignore the potential environmental risks that may be associated with a property.

"Because of strict and retroactive liability provisions in many state and federal environmental laws, purchasers and investors of real estate and businesses can incur enormous cleanup liability, even where they are not responsible for the contamination," said Lawrence Schnapf, an environmental lawyer with the New York law firm **Schulte Roth & Zabel** and a blogger on Commonground, a social network for environmental and property due diligence professionals.

This is especially true of property that housed or is adjacent to gas stations, car dealerships, dry cleaners and industrial operations where hazardous materials were used or stored. Even when contamination and underground fuel tanks are known entities, the key factor is how well these problems are examined and identified. It is far better to deal with "environmental hair" before foreclosure than afterward. Not only will the market discount the property value heavily if environmental liabilities are not known or identified, the lender may be forced to assume costly liabilities by simple virtue of their ownership.

However, lenders, especially small and regional banks, in many instances don't look at environmental issues. If they do, they may rely on simple database screens or commodity-style Phase I assessments that either don't do a thorough report on environmental liabilities, or the reports are not compliant with current EPA standards, Schnapf said. The assessment must be conducted according to the American Society of Testing & Materials E1527-05 or the EPA's AAI Rule standard.

In addition, due to the rising number of bank failures, the number of distressed asset opportunities is rapidly rising, but 20 percent to 30 percent of the loans from failed banks could have environmental issues that will affect the value of the property, according to Environmental Data Research.

How do you protect yourself? Begin with appropriate due diligence.

A hazardous materials screening, akin to a broker opinion of value, can provide valuable information by answering the following questions:

- Should a Phase I environmental assessment be completed?
- Will working with the property owner on restructuring the loan be advantageous?
- Does an environmental insurance policy need to be obtained?
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If more in-depth screening is warranted, one approach is to complete a Phase I assessment. This can protect the lender or subsequent purchaser from environmental risks and add value to REO because environmental issues are clearly defined, liability is minimized and a strategy can be implemented to address them. But do not cut corners to save a few bucks in the short term by ordering an assessment based on price alone, or by relying on an older Phase 1 report, Schnapf said.

Not all Phase I assessments are created equal. Verify the qualifications, level of expertise and years of experience of the environmental consulting firm and its environmental professionals. You may pay a little more -- it can range from $2,500 to $25,000, depending on the size and complexity of the site -- but the savings in terms of environmental liability could far out weigh the additional cost. In addition, REO managers sometimes rely on older reports -- which is not only inconsistent with AAI, but also dangerous, due to the poor quality of reports that dominated the market between 2004 and 2007, Schnapf cautioned.

A lender should also consider consulting an attorney who specializes in environmental law prior to taking any action that implies it is exercising control over a potentially contaminated property.

In conclusion, having a complete understanding of the environmental issues of a property prior to foreclosure or purchase is critical to avoiding risks and liabilities, and for creating the best value and opportunities for distressed assets.

Johnson is vice president of SCS Engineers, an environmental consulting firm, and serves as principal of its San Diego office. He has developed risk management programs for contaminated properties with market values in excess of $100 million.