

Environmental audits are critical to protect financial institutions from tremendous liability for the environmental problems of their borrowers. But every property does not need the most detailed—and most expensive—audit possible. In this article, Larry Schnapf explains how to choose an audit that is rigorous enough to protect the lender yet does not torpedo worthy transactions.

How to Conduct an Environmental Due Diligence Investigation

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A SERIES OF FEDERAL COURT DECISIONS has expanded the liability that financial institutions may face under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) (42 U.S.C. 9601 *et seq.*). In the wake of these decisions, environmental due diligence investigations have become an essential tool for lenders marketing and managing commercial loans.

These investigations, also known as environmental assessments or audits, serve several purposes. Lenders can use them to evaluate the creditworthiness of a prospective borrower. The audits can reveal, for instance, if a heavily leveraged borrower may be required to fund a cleanup that could render it insolvent. The audits also can help lenders to exclude contaminated properties from a transaction or to decide against foreclosing on properties containing environmental hazards.

In cases where a loan's purpose is to finance the purchase of an asset or stock so the prospective borrower can become the parent or successor corporation or the controlling shareholder, an environmental investigation can identify the potential liabilities of the target company. Doing so is crucial given the trend, under CERCLA, toward expanding

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the liability of parent and successor corporations. (See *United States v. Kayser-Roth Corporation*, 724 F.Supp. 15 (D.R.I. 1989); *Smith Land & Improvement Corp. v. Celotex Corp.*, 851 F.2d 86 (3d Cir. 1988).)

Besides providing lenders with the critical information they need for shaping their business decisions, environmental investigations can help preserve liability defenses that may be available to lenders under federal and state environmental laws.

Due Diligence Requirements

Under CERCLA, owners and operators of facilities or vessels (that is, equipment, containers) may be strictly and jointly liable for cleanup costs stemming from releases or threatened releases of hazardous substances. This liability applies both to a site's current owners and to past owners or operators who were responsible for the release of the hazardous substances.

As a rule, CERCLA exempts from liability holders of security interests in contaminated property by excluding them from the definition of owners or operators. Lenders may lose their immunity, however, and become liable for their borrower's environmental liability if they acquire actual title to the contaminated property or participate in the management of the borrower's operation. (See *United States v. Maryland Bank & Trust Company*, 632 F.Supp. (D. Md. 1986); *Guidice v. BGF Electroplating & Manufacturing Company, Inc.*, 732 F.Supp. 556 (W.D. Pa. 1989).)

This potential liability poses a dilemma for lenders. They may be able to avoid liability by not foreclosing on the property. This option, though, can prove impractical, since real estate is often an insolvent borrower's only valuable asset.

Moreover, it can prove difficult to determine when a lender becomes sufficiently involved in its borrower's operations to become liable under CERCLA, since the courts have not precisely defined the actions that constitute "participation in the management of a facility." During the life of a loan, lenders take a wide range of actions that, taken one by one, may not seem to evidence control over a borrower. However, when a court views these discrete and isolated actions in total many years later, it may appear that a bank did exercise sufficient control to become subject to CERCLA. (See Schnapf, "What To Do When Your Borrower Faces Environmental Problems," Vol. 5, No. 3, *Commercial Lending Review* (Summer 1990).) Indeed, a federal court of appeals recently ruled that a lender could be liable if it simply had the ability to control or otherwise influence its borrower's operations (*United States v. Fleet Factors*, 901 F.2d 1550 (11th Cir. 1990)). Most recently, in *In re Bergsoe Metal Corporation* (910 F.2d 668 (9th Cir. 1990)), a three-judge panel ruled that a creditor had to be actively involved in the management of a facility before it could be liable under CERCLA. Equally significant, the court also held that a creditor who foreclosed on contaminated property would not lose its immunity from liability as

long as the action was taken to protect its security interest. By linking foreclosure with intent, the decision directly contradicts *Fleet Factors* as well as a number of federal district court decisions that have held that a bank will be liable if it forecloses on property regardless of the length of time its holds title. (See "Fleet Factors Update: Participation in Management" on page 41 in this issue.)

Because of the harsh impact that CERCLA has had on innocent landowners, Congress crafted an "innocent purchaser's" defense. This defense can insulate from liability lenders who conduct an "appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice" before booking the loan or foreclosing on the property (42 U.S.C. 9601(35)).

To determine whether a lender made an "appropriate inquiry," the law requires that a court 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" (42 U.S.C. 9601(35)(B)).

Despite these requirements, CERCLA doesn't precisely define what constitutes an "appropriate inquiry," so courts will determine on a case-by-case basis if a lender conducted an adequate investigation. Clearly, however, if an undeveloped parcel sells 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, a court may consider metal drums or distressed vegetation as signs of the "likely presence of contamination," so failure to conduct a walking tour of the site might prevent a lender from using 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 ("Environmental Hazards Management Procedures," August 1, 1988). The Federal Home Loan Bank Board (FHLBB) issued guidelines for environmental risk policies for thrifts ("Environmental Risk and Liability," February 6, 1989 (Thrift Bulletin 16)). In addition, the Federal Home Loan Mortgage Corporation (Freddie Mac) has circulated proposed rules for lenders whose mortgages they purchase. These requirements apply only to residential properties. However, since federal due diligence standards do not exist for commercial properties, lenders have tended to adopt the environmental auditing requirements set forth by Fannie Mae and the FHLBB.

Fannie Mae requirements

Under the Fannie Mae underwriting requirements for multifamily properties, environmental audits are divided into two stages. In the first stage, lenders must review easily accessible information about sites with hazardous waste problems and Superfund sites—that is, information available on federal and state environmental databases—for the property in question and for all sites within one mile.

In the second stage, lenders must conduct an on-site inspection of the property. The on-site inspection must reveal that there are no visible signs of friable asbestos or urea-formaldehyde insulation or concentrations of hazardous substances that exceed state or federal guidelines. Lenders must also periodically confirm in writing that the borrower is maintaining the property in accordance with environmental laws. The second stage of the audit involves more extensive investigation and may include sampling of soil.

Fannie Mae may refuse to purchase a loan if a structure is built over a landfill, if there exist concentrations of hazardous substances above state or federally established levels, or if corrective action cannot be taken because of physical constraints or the financial inability of the borrower.

The Fannie Mae requirements for single-family homes place the burden for reporting environmental problems on real estate appraisers. When they determine market value, appraisers must take into account environmental conditions that are common knowledge, which probably means any adverse conditions documented in public records, that is, spill reports, notices of violations, or other records maintained by environmental agencies.

SEC regulations

Identifying environmental problems is also important for compliance with the United States Security and Exchange Commission (SEC) reporting requirements for environmentally related matters. The SEC requires that a publicly held company report any administrative or judicial proceeding either begun or that the company knows is contemplated under federal, state, or local environmental laws if the proceeding will materially affect the business or financial condition of the corporation; if the damages, sanctions, or likely capital expenditures needed to comply with environmental regulations will top 10% of the current assets of the corporation; or if fines or penalties are likely to exceed \$100,000 (17 C.F.R. 229.103(5)(A)-(C)). Failure to comply with these requirements may result in the SEC's initiating enforcement proceedings and may subject a corporation to shareholders' class actions and derivative suits.

How to Conduct an Environmental Audit

I strongly advise conducting environmental due diligence examinations on each parcel that will be part of a transaction. However, because of cost considerations or time constraints, the parties in multiparcel transactions often restrict site assessments to a few properties. They usually select sites that are likely to have the worst problems, those with industrial or manufacturing operations, or those that are the most valuable. For example, if a multimillion-dollar transaction is at stake, the lender might safely ignore sites that it suspects have about \$10,000 of liability; for a \$1 million deal, several of those sites could pose relatively severe problems.

The lender should not succumb to competitive pressures and accept inadequate environmental audits; faulty audits may prevent lenders from invoking the innocent purchaser's defense. This fact was demonstrated in *In re BCW Associates Ltd. v. Occidental Chemical Corp.*, No. 86-5947 (E.D. Pa. Sept. 30, 1988). A warehouse buyer unsuccessfully raised the innocent purchaser's defense and was found liable for cleanup costs to remove lead-contaminated dust, even though the purchaser's environmental consultant had issued an unqualified opinion that no hazardous substances existed at the property. The court found that the plaintiff had failed to exercise due care. The problem? The report had identified a possible area of environmental concern, but the plaintiff did not investigate further because of the expense of additional testing. The court found that the discounted purchase price of the building, combined with the fact that the buyer knew it was 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 has three phases. After each phase, lenders use the information gathered to decide whether to investigate further and to plan how extensive any additional study should be.

Phase I Audit: Preliminary Site Assessment

Environmental consultants commonly call the Phase I environmental risk assessment a preliminary environmental site assessment. The audit usually begins with the preparation of a highly technical questionnaire, which asks for detailed information about the facility's operation. An engineer or the plant manager of the facility must complete this questionnaire. Then the consultant uses information from it to identify areas for further investigation. The lender's counsel may also rely on it to prepare an environmental opinion that will help the bank decide whether or not the advantages of the deal outweigh the environmental risks.

As part of this preliminary environmental assessment, the lender's environmental risk analyst or environmental counsel should review public and private records to find out the present and past regulatory

and operational history of the site.

Lenders should perform the Phase I environmental assessment on any of the following types of proposed collateral:

- industrial properties including iron and steel, petrochemical, pharmaceutical, plastics, paper, glass, mining, metal finishing, electroplating, food processing, or canning establishments as well as properties adjacent to industrial complexes;
- commercial properties that contained or were within a half mile of gasoline service stations, automotive repair shops, dry cleaners, photographic developers, paint operations, hospitals or medical buildings, or jewelers;
- high-tech and electronic companies, such as printed circuit board and computer component manufacturers, that 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, or fertilizers, may have been applied;
- sites that were used as, or are adjacent to, landfills, former town dumps, and waste disposal facilities;
- buildings or properties that may contain asbestos;
- buildings located in regions known to have emissions of radon gas;
- multifamily or single-family residential properties located within a one-mile radius of a site on the National Priorities List (NPL, that is, the Superfund list);
- shopping malls, restaurants, and proposed construction projects that may contain underground storage tanks or may be contaminated from previous uses.

For properties that have these risk factors, the lender's risk analyst or environmental counsel should take these steps:

- Conduct a title search.
- Review facility records.
- Review regulatory compliance records.
- Look at neighboring properties.

Conduct a title search. By reconstructing the chain of title as far back as possible, the lender can learn if the property was used previously for on-site generation, storage, or disposal of hazardous materials. Lenders can obtain this information from title abstracts, tax records, subdivision maps, building or land use permits, and interviews

with local officials. However, if the owner did not operate the site, the title search may not reveal the property's previous operating history or uses.

Review facility records. The seller or borrower can provide valuable historical information, including site plans, plats (that is, area maps), engineering surveys, blueprints, and aerial photographs that show the location of structures, underground storage tanks, PCB (polychlorinated biphenyls) transformers or capacitors, floor drains, sewer lines, lagoons, settling ponds, trenches, railroad tracks, areas of hazardous waste storage, and the presence of asbestos.

Review regulatory compliance records. Businesses that are subject to environmental regulation must maintain a variety of records on the site. They also must report any spills to the state and regional offices of the EPA, notify these offices if certain hazardous substances are present at a plant, and register underground storage tanks.

Look at neighboring properties. Nearby properties can be a source of contamination and can drastically affect the value of mortgaged properties, so lenders should review the uses of property within one mile of the site. Several state and federal databases, such as CERCLIS (a list of sites the government has identified as containing hazardous wastes), SEC filings, and the Agency for Toxic Substance Disease Registry (ATSDR), may be consulted for this purpose.

Phase II Environmental Audit: Site Inspection

The Phase II site inspection should be more thorough than the walk-through in Phase I. An environmental consultant and a representative of the lender should tour all on-site facilities to determine whether or not further investigation is needed. To save time and money on multiparcel transactions, the parties may choose to visit only the most valuable sites or those that are most likely to be contaminated, based on the information obtained in Phase I.

During the tour of the plant, the environmental consultant should investigate the following:

- floors and walls;
- air emission sources;
- wastewater treatment;
- storm water runoff;
- surface and groundwater quality;
- asbestos;
- PCBs;
- raw material storage areas;
- waste storage, treatment, and disposal;
- underground storage tanks (USTs);

- fuel storage and vehicle maintenance areas;
- loading docks, shipping areas, and railroad sidings.

Floors and walls. In manufacturing and processing operations and with any machinery using hydraulic fluids or solvents, check for staining, cracking, or deterioration. These conditions may indicate spillage or careless handling of hazardous materials. Also note the location and condition of floor and sink drains, exposed pipes, and sumps and compare their actual location against the blueprints, since these can serve as collection or discharge points for hazardous materials. For the same reason, determine where the conduits drain.

Air emission sources. Inspect ducts and ventilation equipment for signs of improper emissions, and check air pollution control equipment to determine that it is in compliance with air pollution permits. Include fossil fuel burning equipment, incinerators, and the pollutants they emit in this inspection. Evaluate the cost of installing new pollution control equipment as well as any fines or penalties for noncompliance. Also evaluate the costs of the air-quality impact and health assessment studies that will be needed if additional equipment or permits are required.

Wastewater treatment. Inspect wastewater treatment facilities and outfalls and check that they comply with permit effluent limitations as well as any local pretreatment requirements. Facilities generally discharge waste into municipal sewer systems, although some may still discharge noncontact heating or cooling waters (that is, water that is assumed not to be contaminated because it does not come into contact with other materials) into local waterways.

Storm water runoff. Locate discharge and collection points for the storm water sewers and determine where the storm water runoff discharges. Into the municipal sewer system? Into a wetland? Into a subsurface disposal system or surface waters? Or does it come into contact with process water (that is, water that mingles with other substances as part of the operating or manufacturing process) or wastewater before it discharges. Inspect the collection points spill control or containment structures to see if contaminants are mixing with the storm water. If the storm water conduits discharge into surface water, determine if that stream is subject to the individual control strategy (ICS) program (that is, a federal program under which states are required to develop strategies to minimize or eliminate toxic substances discharged into streams that may be contaminated with toxic pollutants). If it is, the storm water discharge will require a permit and may have to be treated before discharge.

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. Also identify sources of discharge into those bodies of water and drinking water sources, such as wells. As-

certain if groundwater monitoring wells are present and review results of any previous 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. Inspect these areas and note the condition and contents of drums, barrels, and cans. Unlabeled, deteriorating, or open hazardous waste containers may indicate poor housekeeping; more important, they may be signs of noncompliance with state and federal environmental, safety, and health regulations and codes.

Waste storage, treatment, and disposal. Improper waste storage and disposal may lead to extensive groundwater and soil contamination requiring expensive remediation. It may prove costly to upgrade inadequate storage areas in order to meet federal-government design standards, such as requirements for impervious linings and diking. Accordingly, locate and examine the condition of the waste management facilities, such as lagoons, impoundments, holding ponds, tanks, and drum storage areas. Note any signs of spillage from overloading or leakage from poor construction. Also look for discolored soil, stretches of bare soil, or dead or distressed vegetation. These conditions may indicate that waste storage units were formerly on the site.

Underground storage tanks (USTs). Leaking underground storage tanks can be a major source of soil and groundwater contamination. Find out the location of all buried tanks, their age, construction, and contents. Pay special attention to caps or fillpipes that may point to abandoned USTs. Determine if the USTs 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 is another potential cause of soil and groundwater contamination. Look for signs of staining or deterioration of pavement or concrete in fuel storage and vehicle maintenance areas and determine the purpose and discharge point of all drains. If an oil/water separator exists, determine its capacity, age, and construction, review permits, and check any inspection reports. Malfunctioning oil/water separators 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 seen, lenders should consider authorizing the use of metal detectors to identify buried metal structures, such as storage tanks, and a volatile organics analyzer, which can "sniff" gases evaporating through the soil from buried storage facilities or plumes of contamination in groundwater.

The Phase II investigation typically takes about three weeks and costs between \$2,000 and \$10,000 per site. When the environmental

consultant finishes the inspection, he or she should prepare a report for the lender. The report should summarize the results of the investigation and indicate areas of environmental concern that may require additional investigation.

Phase III Environmental Audit

The Phase I and II examinations are usually sufficient for determining potential liability in commercial, light industrial, and small parcel acquisitions. However, when your borrower acquires heavy industrial properties or when the early stages of the audit turn up areas of concern, lenders may need more extensive investigation, including soil sampling, groundwater and surface water monitoring, or stack emission sampling. Finding out the extent of soil and groundwater contamination can be extremely costly, especially for transactions in the \$1 million to \$10 million range. Since transactions of this size constitute the core business of many financial institutions, cleanup costs may kill otherwise viable deals.

The Phase III investigation usually includes testing underground storage tanks, analyzing soil gas to identify the presence of volatile organic compounds or petroleum hydrocarbons, and sampling inside buildings suspected of containing asbestos. It also includes sampling groundwater and surface water, analyzing local geologic and hydrogeologic conditions, listing individual groundwater wells that may be affected by the property, sampling soil and groundwater, and installing monitoring wells if it appears that groundwater contamination exists.

The Phase III investigation may take several months and—depending on the size and type of operations—can cost between \$30,000 and \$60,000 per site. After the investigation is completed, the consultant should prepare a draft of the final environmental assessment report, which the lender's counsel should review. The consultant should send the final report directly to the lender to help establish that the lender conducted a due diligence investigation.

Hiring the Consultant

To assure that the environmental investigation is performed in a commercially reasonable manner and to preserve the innocent purchaser's defense, lenders should retain an environmental consultant for a Phase I audit. However, to avoid the possibility that a court will consider the lender to be in control of the facility, you should not, as a rule, hire the consultant for the Phase II or Phase III assessments. Instead, the borrower, a trustee, or the lender's outside counsel should do the hiring.

After selecting the consultant, the lender should request a scope of work, which identifies the tasks the environmental consultant plans to perform. The lender's environmental counsel should review this document to make sure it will achieve the objectives outlined by the bank.

Many consultants issue a confirmation letter and a "terms and conditions" document, which they intend to serve as the contract between the consultant and the lender. The lender's environmental counsel should review these documents, since they usually contain boilerplate provisions not tailored to a particular bank's needs. In addition to the project description and cost, the lender should make sure that the terms and conditions document contains the following six provisions:

- The lender should not indemnify the consultant except for damages stemming from the lender's own negligence.
- The environmental consultant should furnish the financial institution with evidence of liability insurance and should name the bank as an additional insured on its policy.
- Accrual periods for interest due to nonpayment should not be shorter than 60 days to allow the bank time to process the consultant's invoices.
- The consultant should visit the premises at his or her own risk. Since lenders do not generally possess or own the property they want investigated, they should not be liable for failing to provide the consultant with information about concealed or dangerous conditions on the site.
- All materials, including reports, drafts, and field notes, generated during the course of the project should become the property of the financial institution and must not be disclosed to any third party unless expressly approved by the financial institution.
- The lender should reserve the right to terminate the project at any time for any reason. If the lender does terminate, the environmental consultant should not incur any further charges unless specifically authorized by the lender.

Confidentiality of Environmental Audits

Regulatory authorities and neighboring parties who have filed a toxic tort action may attempt to use environmental audits as evidence to establish the existence of contamination or unlawful practices. In addition, a mortgagee or owner of contaminated property may want to keep an audit confidential to guard against a decline in property values. Environmental audits may be subject to discovery unless a lender can assert a confidentiality claim based on the attorney-client privilege, the work product rule, or the self-evaluating privilege.

The *attorney-client privilege* is the broadest of these three. To qualify for it, lenders should have their counsel order the audit, the audit should indicate that counsel required the information in order to render a legal opinion, and distribution of the report should be limited to a small number of people.

The *work-product rule* is generally limited to materials or information collected or prepared in anticipation of litigation. This privilege is narrower than the attorney-client privilege, because a court can order the disclosure of facts contained in a report if substantial need exists for the information and the party requesting the information would suffer undue hardship if forced to obtain the facts by other means.

The *self-evaluating privilege* is designed to encourage companies to evaluate and correct noncompliance with laws by subjecting the information collected to a privilege. It has been widely accepted in nonenvironmental matters and, arguably, could be asserted for environmental compliance audits.

Disclosures to Preserve Innocent Purchaser's Defense

CERCLA and other environmental statutes contain notification provisions that require owners or operators of facilities to disclose the existence of spills or contamination above certain concentrations. A financial institution that has information that indicates such a reporting threshold has been exceeded usually will not have to disclose the information to regulatory authorities so long as the lender is not an owner or operator of the site nor in possession of the facility.

If, however, the lender wants to foreclose and sell the property, it might consider furnishing the information to the regulatory authorities. The lender could then attempt to negotiate an agreement allowing it to sell the property and receive a covenant not to sue from the government in exchange for a *de minimis* payment.

Lenders should be aware that they can forfeit their innocent purchaser status. Under CERCLA, an innocent purchaser must disclose the existence of contamination in order to preserve the innocent purchaser's defense (42 U. S. C. 9601 (35)(c)). Thus, a lender who acquires title as an innocent purchaser and performs an environmental audit before selling the property would have to reveal the existence of any contamination to the purchaser in order to continue to be insulated from liability. To assure that this protection is maintained, lenders should make it a practice to tender copies of environmental reports to prospective purchasers.