## **Commercial Mortgage Insight**<sub>®</sub>

## During Pre-Foreclosure, Complete A New ESA

Foreclosing on a property can expose a lender to a host of new liabilities, even if an ESA was conducted when the loan was originated.

By Kimberly K. Houston

he number of foreclosures on commercial properties continues to rise, and these troubled properties include everything from office buildings, industrial buildings and retail properties to hotels, casinos, condominiums and apartments.

As part of the pre-foreclosure process, lenders need to engage an environmental professional to complete a Phase I environmental site assessment (ESA) that is compliant with the industry standards of ASTM 1527-05 and the Environmental Protection Agency's All Appropriate Inquiry (AAI) rule.

The lender should order a Phase I ESA as part of the pre-foreclosure process, even if a Phase I ESA was completed at the time of consummation of the loan.

The AAI rule primarily applies to borrowers that want to claim Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) liability protection as an innocent landowner, bona-fide protective purchaser or contiguous property owner.

Typically, banks that hold mortgages on property as secured lenders are exempt from CERCLA liability, provided that certain very specific criteria are met. CERCLA Section 101(20) contains a secured creditor exemption that eliminates owner-operator liability for lenders that hold ownership in a CERCLA facility primarily to protect its security interest in that facility, pro-

vided it does not "participate in the management of the facility."

"Participation in management" does not include actions such as inspection of the property, requiring a borrower to take action to address contamination, providing financial advice, or renegotiating or restructuring the terms of the loan.

In addition, the secured creditor exemption provides that simply

foreclosing on a property does not result in liability for a bank, provided the bank takes "reasonable steps" to divest itself of the property "at the earliest practicable, commercially reasonable time,



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on commercially reasonable terms."

Generally, a lender may maintain business activities and close down operations at a property, so long as the property is listed for sale shortly after the foreclosure date, or at the earliest practicable, commercially reasonable time.

However, with the state of today's market, which includes the increase of commercial properties on the market that are not being resold and/or may remain vacant for some time, lenders may find themselves managing a fore-closed property.

In order to protect themselves from losses and to identify liability issues, lenders need to use the Phase I ESA as a foundation in the decision-making process when contemplating foreclosure on a commercial property.

## What CERCLA addresses

The Phase I ESA primary function is to identify recognized environmental conditions (RECs) in respect to the property. ASTM defines a REC as the "presence or likely presence of any hazardous substance or petroleum product on a property under conditions that indicate an existing release, a past release or a material threat of a release of any hazardous substance or petroleum product into structures on the property or into the ground, groundwater or surface water of the property."

In-depth review of the historical usage of a property, along with a thorough property inspection, facilitates the identification of potential RECs. The Phase I ESA may recommend that additional investigation, such as file reviews at the appropriate local or state agencies, be conducted to provide additional information about the potential REC.

In a pre-foreclosure situation, the completion of a regulatory file review can provide critical information to the lender that can identify the extent of contamination and potential liability issues for the lender in the event of a foreclosure.

In addition, the Phase I ESA may recommend that a Phase II ESA be conducted, which includes the testing of subsurface soil and/or groundwater at the property. If the results of the environmental investigations do reveal potential environmental issues, the lender may have to reconsider the property value and the wisdom of foreclosure.

While CERCLA addresses the potential health hazards posed by hazardous substances at properties, lenders need to evaluate non-ASTM environmental concerns, such as asbestos, leadbased paint, lead in drinking water, wetlands issues, radon and vapor intrusion on a pre-foreclosure property.

"A lender's exposure to environmental liability may increase significantly if it takes title to real property held as collateral," writes Thomas A. Missimer in "A Lender's Guide to Environmental Liability Management."

"The institution should evaluate the potential environmental costs and the potential for environmental liability in conjunction with an assessment of the value of the collateral in reaching a decision to take title to the property by foreclosure or other means," he continues.

## Foreclosure proceedings

The cost of an environmental cleanup or remediation for non-ASTM items can be costly. The lender may require that more than a cursory reporting of these non-scope items be included in the Phase I ESA.

Along with visual observation, review of available records and conclusions based on the age of the property, the lender may require that additional testing or investigation be completed in conjunction with the Phase I ESA.

Additional specialists, such as a wetlands mapper, may need to be consulted, especially for undeveloped properties. The environmental concerns identified by the environmental professional may not necessarily constitute liability on the part of the lender. However, the issues need to be clearly identified so that the lender can consult an environmental attorney, if necessary.

As in the residential housing market, there is a push from borrowers in the commercial mortgage market for lenders to provide alternative structures on their loans, rather than to begin foreclosure procedures.

Because property owners can tie up a property in bankruptcy court for a year or more, lenders are proceeding with foreclosures on properties that are more than 30 days overdue. It is also crucial to begin the foreclosure proceeding while the borrower is still cooperative in order to assure that access can be granted for the Phase I ESA site inspection.

This may be particularly crucial for industrial properties. The lack of access can alter the findings of a Phase I ESA, and the lender should be hesitant to proceed with a foreclosure without a thorough site inspection.

Although the number of foreclosures has increased in the commercial real estate segment of the due diligence market, ASTM 1527-05, AAI and the identification of potential RECs remain the industry standards for Phase I ESAs. In a foreclosure situation, the lender should utilize the Phase I ESA as one of the tools in the decision-making process in order to evaluate the potential liability in the event that they proceed with the foreclosure. **CMI** 

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