

## Chapter 5. Environmental Risk Management

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This chapter sets out SBA policy and procedures for managing environmental risks associated with SBA loans in regular servicing or liquidation status.

### A. Overview

#### 1. Environmental Risks

For secured creditors, the risks associated with Contaminated collateral include, for example:

- a. Impairment of the Borrower's ability to repay the loan due to the high cost of Remediation, regulatory fines and penalties;
- b. Diminishment of the value and marketability of the collateral;
- c. Direct liability for tort claims and Remediation by becoming an owner or operator of the Property, (e.g., by acquiring title at a foreclosure sale or by taking over the operation of the Borrower's business); and
- d. Loss of lien priority if a Governmental Entity cleans up the Property.

#### 2. Definitions

Definitions of the environmental terms used in this SOP, which are capitalized when they appear, are located in Appendix 2 of [SOP 50 10](#), the most current version of which is accessible from the [SOP section](#) of SBA's Web site. The defined terms include, for example, the term "Property," which means commercial real property and does not include personal property or residential real estate.

### B. General Requirements

Prudent servicing and liquidation of an SBA loan includes:

1. Conducting adequate due diligence before taking any Loan Action that could result in a loss, or increase the risk of loss, due to actual or alleged presence of Contamination;
2. Monitoring the loan for compliance with the environmental covenants in the Loan Documents, and requiring the Borrower to take appropriate corrective action if necessary; and

**Note:** Changes in the Borrower's financial condition that could signify an increase in environmental risk include, e.g., regulatory fines discovered while reviewing financial statements. Activities that could signify an increase in environmental risk include, e.g., failure to maintain Engineering Controls or evidence of a Release discovered during a site visit.

3. Compliance with Environmental Laws that allow secured creditors to avoid or significantly limit potential liability.

**Note:** Many Environmental Laws provide secured creditors with a “safe harbor” from liability as an owner or operator. Two of the most important laws are the [Comprehensive Environmental Response, Compensation, and Liability Act](#) (“CERCLA”) and the [Resource Conservation and Recovery Act](#) (“RCRA”). To qualify for the exemption under CERCLA or RCRA, the most critical requirements are that the secured creditor: (1) hold indicia of ownership primarily to protect its security interest; (2) take no action that could be construed as “participating in the management” of the Borrower’s facility; and (3) attempt to divest itself of Contaminated acquired collateral at the earliest practicable and commercially reasonable time using commercially reasonable means. For Information on the types of activities that constitute “participating in the management” of a facility or UST system, with regard to CERCLA see [CERCLA Lender Liability Exemption: Updated Questions and Answers](#); and with regard to RCRA, see [40 C.F.R § 280.210](#). Consult legal counsel for loan-specific information.

### **C. When an Environmental Investigation is Required**

An Environmental Investigation must be conducted before taking any Loan Action that could result in a loss, or increase the risk of loss, due to the actual or alleged presence of Contamination. For example, an Environmental Investigation must be conducted before:

1. Accepting Property as substitute collateral;
2. Releasing a lien on collateral for substantially less than its estimated Recoverable Value based on unsubstantiated allegations of Contamination;
3. Abandoning collateral, which would otherwise have Recoverable Value, based on unsubstantiated allegations of Contamination;
4. Acquiring title to Property held as collateral, e.g., by purchasing it at a foreclosure sale or accepting a deed-in-lieu of foreclosure;
5. Taking over the operation of a business that uses Hazardous Substances or is located on Contaminated Property regardless of whether the Borrower owns the Property;
6. Selling REO or acquired personal property collateral for substantially less than its appraised value based on unsubstantiated allegations of Contamination; and
7. Abandoning REO or acquired personal property collateral based on unsubstantiated allegations of Contamination.

### **D. Environmental Investigation Process for Loans in Regular Servicing Status**

Environmental Investigations in support of regular loan servicing activities, e.g., substitution of collateral, should be conducted in accordance with [SOP 50 10](#).

### **E. Environmental Investigation Process for Loans in Liquidation Status**

Environmental Investigations in support of liquidation activities, e.g., acquiring Property at a foreclosure sale, should be conducted as follows:

## 1. Scope of investigation

The amount of due diligence must be prudent based on the loan specific circumstances such as the Property's appraised value, the amount owed on senior liens, the SBA loan balance, the activities conducted at the Property, the results of previous Environmental Investigations, access to the Property, and the cost and time involved.

## 2. Use of Environmental Professionals

Environmental Investigations on loans in liquidation status must be conducted by an Environmental Professional except for the Environmental Questionnaire ("EQ") portion of an Environmental Investigation that consists of an EQ and Records Search with Risk Assessment ("RSRA").

## 3. Reliance Letter Requirement

An Environmental Investigation Report prepared by an Environmental Professional must be accompanied by a Reliance Letter unless the Environmental Investigation consists of an EQ and RSRA. (See Appendix 3 to [SOP 50 10](#) for the Reliance Letter template.)

## 4. General Procedure

Generally, the following steps should be taken to conduct a post-default Environmental Investigation that will provide adequate information for a prudent lender to make an informed decision regarding the risks of Contamination.

### Step 1. Order an Environmental Site Assessment ("ESA")

**High Risk**—If the risk of Contamination appears to be high, begin with a Phase I ESA. Generally, the risk should be considered high if, for example, there are underground storage tanks at the Property, a NAICS Code for a past or present use of the Property matches one on the List of Environmentally Sensitive Industries (Appendix 4 to [SOP 50 10](#)), or past Environmental Investigations have concluded that the Property is Contaminated or that there is a high or elevated risk of Contamination.

Exception for Non-Industrial Condominiums: The Environmental Investigation of a condominium in a non-industrial, multi-unit building may begin with a Transaction Screen or an EQ and RSRA.

**Low Risk**—If the risk of Contamination appears to be low, begin with a Transaction Screen or an EQ and RSRA.

### Step 2. Conduct Additional Necessary, Cost-effective Inquiries

If a prudent lender could not make an informed decision based on the Environmental Investigation Report from Step 1, conduct any additional cost-effective inquiry recommended in the Environmental Investigation Report or otherwise needed to obtain enough information to make an informed decision. For example, when the Property appears to have significant Recoverable Value:

- (1) A Phase I ESA should be conducted if a Transaction Screen or EQ and RSRA shows a high or elevated risk of Contamination;
- (2) Inquiries regarding environmental problems beyond the scope of a Phase I ESA (e.g. asbestos), should be conducted if the problem could have a material effect on the Recoverable Value of the Property;
- (3) A Phase II ESA should be conducted if it is necessary to determine the nature and extent of Contamination identified by a Phase I ESA; and
- (4) A Remediation estimate should be obtained if Remediation is recommended in a Phase II ESA Report.

**Note:** For guidance on how to prepare a Remediation estimate, see ASTM E2137-06 (*Standard Guide for Estimating Monetary Costs and Liabilities for Environmental Matters*). Note also that SBA officials may request an estimate from the SBA environmental engineers at the SBA [Sacramento Loan Processing Center](#).

### Step 3. Additional Requirements for Gas Stations and Dry Cleaners

If, after obtaining a Phase I ESA, a prudent lender would obtain additional information before making a decision regarding Property associated with the operation of a gas station, commercial fueling facility, or a dry cleaner that uses Hazardous Substances, then the Environmental Investigation should also include:

- (1) A Phase II ESA conducted by an independent Environmental Professional with three years of full-time relevant experience who holds a current Professional Engineer's or Professional Geologist's license;
- (2) Any further investigation recommended in the Phase I ESA or Phase II ESA Report;
- (3) An estimate that covers the method, cost and time required for completion of any recommended Remediation; and
- (4) Testing of the equipment related to the operation of the facility.

**Note:** Generally, if a gas station or dry cleaner has been in operation for five years or more, there is a high probability that the Property is Contaminated.

### Step 4. Extra Requirement if Taking Over Business Using Hazardous Substances

- (1) Environmental Regulatory Compliance Audit

Generally, an environmental regulatory compliance audit should be conducted prior to taking over the operation of a business that handles Hazardous Substances. The audit should be conducted in substantial compliance with ASTM E2107-06 (*Standard Practice for Environmental Regulatory Compliance Audits*).

**Note:** Unknown regulatory compliance violations can significantly diminish a secured creditor's estimated recovery. For example, the cost of obtaining licenses and permits needed to operate the business can be substantial, and outstanding regulatory fines and enforcement actions can have a chilling affect on the price potential purchasers are willing to pay for the business assets.

(2) Practice Tip

To avoid "participating in the management" of a Borrower's business and losing the secured creditor liability exemption, it is generally advisable to have a receiver appointed by the court to take possession of the collateral and operate the business. (See Chapter 21 for SBA requirements pertaining to Non-routine Litigation such as receivership proceedings.)

## **F. Environmental Investigation Reports**

The results of an Environmental Investigation must be set out in a written Environmental Investigation Report, which must be kept in the Loan File. An Environmental Investigation Report should be less than 180 calendar days old at the time it is relied on.

## **G. Remedial Action by Secured Creditor**

Given the complexity of the applicable Environmental Laws and the risks involved, Lenders should obtain a legal opinion from an attorney with Environmental Law expertise before undertaking Remedial action. (See [40 C.F.R. § 280.210\(b\)\(2\)\(i\)\(B\)](#), which deals with participating in the management of underground storage tanks ("USTs"), as an example of the risks and complexity of the law.)

## **H. Taking Title to Contaminated Property or Control of Business with Environment Risks**

### **1. When Appropriate**

Title to Contaminated Property should not be acquired, and businesses that use Hazardous Substances or are located on Contaminated Property should not be taken over, unless despite the risk of incurring liability as an owner or operator, a prudent lender would do so based on the estimated net recovery.

### **2. Requirement – SBA's Prior Written Approval**

Lenders must obtain SBA's prior written consent before taking title to Contaminated Property or taking over the operation of a business that uses Hazardous Substances or is located on Contaminated Property regardless of whether the Borrower owns the Property.

### **3. How to Obtain SBA Approval**

A written request must be submitted to the appropriate SBA Loan Center.

#### 4. Request Format

The request, which must be accompanied by the appropriate Supporting Documents, must include a thorough analysis of all the relevant factors to determine whether a prudent lender would take the proposed action despite the risks. Such factors and Supporting Documents should generally include:

**a. Appraised Value of Collateral to be Acquired**

Provide the appraised value of the Property supported by a copy of the post-default Appraisal.

**b. Liquidation Value of Collateral to be Acquired**

Provide the estimated Liquidation Value of the Property and explain the basis for the estimate.

**c. SBA Loan Balance**

Provide the SBA loan balance supported by a copy of the transcript of account or other credible evidence of the loan balance.

**d. Amount Owed on Senior Liens**

Provide a list of senior liens against the collateral, including landlord liens and tax liens, and the amount owed on each, supported by a copy of:

- (1) Schedule B of the post-default title report;
- (2) A current UCC lien search if the request includes personal property collateral or taking over the operation of a business;
- (3) Any senior lienholder agreement, landlord lien waiver, subordination agreement or other Loan Document that establishes the priority of the liens against the collateral; and
- (4) Transcript of account or similar proof of compliance with any provision in the foregoing documents that requires a senior lender to subordinate any portion of the senior loan to the SBA loan (e.g., Default Charges).

**e. Foreclosure Costs**

List the foreclosure costs including any extraordinary expenses such as the legal fees and administrative expenses associated with a receivership.

**f. Nature and Extent of the Contamination**

Provide a summary of the nature and extent of the Contamination supported by copies of the Environmental Investigation Report(s) required by Paragraph E.

### **g. Clean-up Costs and Liability**

Indicate whether Remediation is required or on-going, and:

- (1) If Remediation is not required—attach a copy of the no further action letter, closure letter, or functional equivalent from the responsible Government Entity.
- (2) If Remediation is recommended—attach a copy of any document that: (a) provides a description of the recommended method and cost of Remediation and anticipated completion date; (b) that establishes the identity of those responsible for Remediation (e.g., Superfund consent decree); or (c) that demonstrates the ability of the responsible party to pay for the cost of Remediation.
- (3) If Remediation is on-going—attach a copy of any document that shows the progress of the cleanup, or that the Person conducting the cleanup has sufficient financial resources to complete it.

### **h. Secured Creditor Liability Exemptions**

Provide a list of applicable liability exemptions that the Person who will take title qualifies for, such as the secured creditor exemption under CERCLA, RCRA or a similar state law, the bona fide purchaser exemption under CERCLA § 101(4) and 107(r), or the involuntary acquisition by a government entity exemption under CERCLA § 101(20)(D).

**Note:** Pursuant to [40 C.F.R. § 300.1105\(a\)\(3\)](#), acquisition of title by SBA through foreclosure or a deed-in-lieu while administering an SBA loan program is considered an "involuntary acquisition."

### **i. Mitigating Factors**

List any mitigating factor and attach a copy of the relevant Supporting Document(s), e.g., an indemnification agreement and the indemnitor's financial statement.

Mitigating factors include, for example:

- (1) SBA Environmental Indemnification Agreement—was executed by a Person with sufficient financial resources to cover the cost of Remediation;
- (2) Escrow Account—has been established to cover the cost of a Remediation plan approved by the responsible Government Entity;
- (3) Solvent Government Cleanup Fund—has unconditionally agreed to cover the cost of Remediation; or
- (4) Lender Liability Environmental Insurance—is in place and will cover the cost of Remediation after title is acquired.

### **j. Tort Liability**

Provide information regarding the status and anticipated outcome of any known litigation regarding alleged injury to people, property or natural resources due to Contamination at the Property.

### **k. Exceptions to Title that Impact Marketability**

Review Schedule B of the post-default title report and indicate whether there is any recorded covenant, deed restriction or other exception to title that will have a negative impact on the Property's Recoverable Value such as a covenant that requires future owners of the Property to indemnify a major oil company or a deed restriction that prevents future owners from using the Property for any purpose other than to operate a gas station that sells a particular brand of gasoline.

### **l. Alternative Methods of Recovery**

List and analyze the feasibility of alternative methods of collecting the loan balance that involve less risk. At a minimum, this should include (1) the estimated recovery from other collateral and the Obligors; and (2) alternative methods of liquidation that do not require taking title to the Contaminated collateral such as release of lien for consideration, sale of the Note and assignment of the lien to the purchaser, or appointment of a receiver to operate the business until enough money can be recovered to pay-off the loan or the collateral can be sold.

### **m. Acquired Collateral Divestiture Plan**

Provide a description of the plan for disposing of any collateral to be acquired, which includes the holding and resale costs, as well as an explanation of how easy or difficult it will be to resell. For example, have any third parties expressed an interest in purchasing the collateral? Is it currently listed for sale by the owner? If so, why hasn't it sold?

**Note:** Generally, in order to preserve its liability exemption, a secured creditor is required to try to dispose of Contaminated acquired collateral at the "earliest practicable, commercially reasonable time using commercially reasonable means". For more information, see the applicable Environmental Law. For example, [40 C.F.R. 280.210\(c\)\(2\)\(i\)](#) sets out a "bright line" test under RCRA for determining whether a secured creditor is attempting to sell a gas station in an expeditious manner.

### **n. Other Relevant Facts or Expenses**

List and discuss any other loan-specific relevant facts. For example:

- (1) Remediation by Secured Creditor—Will additional costs be incurred to Remediate the Property prior to listing it for sale? If so, attach a copy of the legal opinion recommended in Paragraph G above, provide a Remediation estimate, and indicate how the costs will be paid;

- (2) Receivership Proceedings—Will a receiver be appointed, for example, to operate the business or sell the collateral? If so, attach a draft Litigation Plan that describes the prior experience and qualifications of the proposed receiver and includes an estimate of costs of the court and receivership proceedings; or
- (3) Emptying and Closing USTs—If there are USTs at the Property and a receiver will not be appointed, indicate whether it will be necessary to empty and close the USTs. (For more information, see, for example, [40 C.F.R. §280.230\(b\)](#).)

**o. Estimated Net Recovery**

Provide the estimated net recovery from taking the proposed action based on the analysis of factors “a” through “n” above.