

One Minute Memo®



New Procedure for Evaluating and Managing Environmental Risks for SBA Loans

The Small Business Administration (“SBA”) has consolidated the procedures for administering “regular servicing” 7(a) loans and those deemed to have “liquidation” status in Standard Operating Procedure (SOP) 50 57 “7(a) Loan Servicing and Liquidation” (“SOP 50 57”) which took effect March 1, 2013. Chapter 5 of SOP 50 57 revises the guidelines for managing environmental risks associated with SBA loans and expands the application of such guidelines beyond actions taken in connection with a defaulted loan to also include actions taken in connection with regular servicing (i.e., collateral substitution or release). SOP 50 57 does not modify the procedures to be followed in connection with originating a new loan in which case, with respect to environmental due diligence, lenders will likely require an acceptable Phase I ESA.

Risks and Requirements

Chapter 5 of SOP 50 57 begins by providing examples of the risks associated with contaminated collateral and the general requirements with respect to assessing and minimizing such risks. Those risks specifically identified include: (a) impairment of Borrower’s creditworthiness as a result of remediation costs and regulatory fines and penalties; (b) inherent declines in the value and marketability of the secured property; (c) direct liability on the part of the lender for tort claims and remediation; and (d) loss of lien priority. Prudent front-end diligence by the lender including requiring delivery of an acceptable Phase I ESA will serve to minimize at the origination stage the potential for these risks to materialize. Chapter 5 of SOP 50 57 sets forth requirements and guidelines for lenders to adhere to in order to limit such potential risk throughout the full term of the loan. Those requirements include (i) conducting adequate due diligence in advance of a servicing matter; (ii) monitoring the loan for compliance with environment covenants; and (iii) complying with environmental laws in such a manner that preserves the lender’s secured creditor exemption. With respect to monitoring the loan, SOP 50 57 suggests that lenders should be alert for regulatory fines when reviewing financial statements as such could signify underlying noncompliance and an inherent increase in environmental risk. As to lender compliance with environmental laws, SOP 50 57 highlights the most important factors that must be met in order for a lender to qualify for the secured creditor exemption under CERCLA and RCRA (with regard to underground storage tanks [“USTs”]), the foremost statutes governing enforcement of environmental contamination and remediation. Those factors include: (1) secured creditor must “hold indicia of ownership primarily to protect its security interest”; (2) secured creditor must not take any action that could be deemed to be “participating in the management” of Borrower; and (3) secured creditor must attempt to divest itself of any contaminated property at the earliest practicable time possible.

Servicing and Liquidating Actions - When an Environmental Investigation is Warranted

As the intent of SOP 50 57 is to consolidate the administration procedures for “regular servicing” and liquidation loans, the actions requiring an environmental investigation have been expanded beyond simply acquiring title at a foreclosure sale or accepting a deed in lieu of foreclosure to now also include various servicing matters including: (i) accepting a property as substitute collateral; (ii) releasing a lien on collateral or selling REO property for substantially less than its recoverable value based on unsubstantiated allegations of contamination; and (iii) abandoning collateral or selling REO property for substantially less than its recoverable value based on unsubstantiated allegations of contamination. In the event of any one of these scenarios, prior to taking any such action, the Lender must follow the environmental investigation procedure set forth in Section D of Chapter 5 of SOP 50 57 which cross references to the environmental investigation procedures to be followed in connection with a new loan as set forth in SOP 50 10.

The Environmental Investigation Procedure for “Regular Servicing” Matters

SOP 50 57 does not materially change the environmental investigation procedure itself. Consistent with the current procedure, the first step of such environmental investigation procedure is to make an initial assessment as to the level of risk of contamination at the property by determining, for example, whether (i) USTs are located at the property; (ii) whether any prior environmental investigations have concluded that the property is contaminated or is otherwise at a high level for risk or (iii) the NAICS code(s) for the current and prior uses of the property matches to a NAICS code associated with an environmentally sensitive industry. If a high level of risk is indicated, the environmental investigation must start with a Phase I Environmental Site Assessment. If a low level of environmental risk is indicated, then the next step of the investigation will be to have the borrower complete an environmental questionnaire and, in some cases, a Records Search must also be conducted along with the environmental questionnaire. The results of these initial inquiries will determine whether additional steps such as conducting a Transaction Screen Search or obtaining a Phase I or Phase II ESA are warranted. If ultimately it is determined that the subject property is contaminated or is undergoing remediation, the servicing action may not be approved unless the risks associated with such contamination or remediation are being effectively managed to the satisfaction of the SBA. In seeking approval of a servicing action notwithstanding contamination or ongoing remediation, a lender must submit to the SBA a recommendation discussing at least the following: (i) the nature and extent of the contamination; (ii) the status, including estimated costs, of the on-going remediation; (iii) the amount of the loan in relation to the estimated or appraised value of the property; and (iv) any mitigating factors that may exist including an environmental indemnification, evidence that remediation is completed, a “No Further Action” letter from the applicable governmental agency, an escrow for clean-up funds and, among others, whether additional collateral is being pledged.

Conclusion

As we emerge from a time in which lenders found themselves increasingly the owners of their collateral, headlines such as “Bank Enters Into Settlement With EPA For Contaminated NY Site” and “Bank Agrees To Reimburse EPA for Post-Foreclosure Removal Action Costs” are not uncommon. Accordingly, the guidelines set forth in Chapter 5 of SOP 50 57 could serve as a best practices tool for any lender, whether making SBA loans or not, in assessing and managing environmental risks not only at the origination stage but also in servicing loans.

To read the full text of Chapter 5 of SOP 50 57, click [here](#).

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