

Federal rules for a bank's environmental liability can be costly, confusing

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Banking institutions complete a variety of forms and reports as a part of the evaluation of collateral for loans. A key part in this process can be to complete an understanding of the potential environmental conditions associated with real estate or a business that might be used for collateral.

Banking institutions often complete internal evaluations based upon various internal criteria, such as loan amount, location and use of property/collateral and existing knowledge of the property and/or loan applicant.

Environmental conditions associated with loan collateral can cause various concerns for banks, such as:

- Environmental conditions can affect the value of the collateral and the bank must fully understand these conditions.
- Environmental conditions have the potential to stress the cash flow of the applicant. Environmental studies and potential remediation can be very costly and incur regulatory orders or legal obligations that would compete with a typical business cash flow stream. The bank has a vested interest in a proper evaluation of the applicant's ability to fulfill loan payments.
- Although federal law conditionally protects the environmental liability of banks in the event that a bank must take the collateral, this process can be costly, and must be fully understood. Often, the banking institution will undertake the use of a third-party environmental study.

In general, there are three levels of environmental studies selected by the bank.

The first is the environmental site visit. In many instances, much is already known about the collateral. A third-party environmental professional conducts a site visit and confirms that environmental conditions are well understood and present low or manageable risks.

The second is limited environmental due diligence. When little is known about a property, but due to various bank internal decisions and a perceived view that the property presents a low risk (greenfield, residential, farm), a transaction screen is completed, which follows federal guidelines. The process involves a cursory level of research and a site visit, and the completion of a detailed questionnaire completed by the environmental professional and an occupant or owner representative.

If this study determines that unacceptable environmental risk has been identified, then further study can be recommended.

The third level of environmental study selected by a bank is the Phase I Environmental Site Assessment. This is the industry standard environmental study. It involves a very detailed

documentation of historical uses of the property and adjacent properties, and must follow federal guidelines for this level of study.

In general, parties that wish to obtain protection from potential environmental liabilities associated with the federal Superfund law must complete the Phase I process. As of Nov. 1, 2006, parties must follow a new federal standard known as the All Appropriate Inquiries process. Although this relatively new Phase I environmental assessment process standard is quite lengthy and should be studied in detail to develop a full understanding, the following new items are included:

- The property's current owner or occupant must be interviewed.
- Past owners of the property may also need to be interviewed, if necessary.
- If the property is abandoned, the owner of a neighboring property must be interviewed.
- If any data gaps (inability to collect various pieces of information) are encountered, they must be fully documented and explained, and could possibly mandate that more environmental work be completed.
- The new standard requires that the Phase I assessment be completed by or under the supervision of an environmental professional. The environmental professional must possess sufficient education, training and experience for this level of work, as described in the federal standard.

When environmental conditions are discovered, the interpretation of their impact becomes extremely important.

The environmental professional must advise the bank and the report user as to the level of response to the report. In some instances, this can involve more detailed study, whereby soil, ground water or building materials are collected for further analysis and later interpretation.

If the additional study concludes that risk or regulatory notifications are recommended, for many banks the loan application process is terminated. However, many tools are available that can manage risk for the buyer such as brownfield and voluntary agreements with the state agency. These agreements can lead to key liability protections, thus satisfying many loan requirements for property valuation and cash flow of the loan recipient.

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