

How to Manage Environmental Issues

Site assessments can turn up risks -- and liability insurance can protect lenders from them

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As home foreclosures increase and continue to make the news, the number of commercial real estate defaults and foreclosures also is climbing. Some may present lenders with particularly unwelcome -- and potentially costly -- environmental issues.

For this reason, it is important for commercial lenders and brokers to be aware of the environmental-risk-management tools available to them and the relative benefits of each.

There are two common ways to address these risks. On the front end, brokers and lenders use environmental site assessments to identify current and historical environmental risks that may affect the underwriting decision. Or they could transfer their environmental risk through environmental insurance.

Here's a look at both options.

To better understand how and why these risks should be addressed, it helps to look at the larger picture.

Each loan request that brokers field and turn to lenders for funding is a potential environmental risk in the event of a foreclosure and repossession. The Asset, Conservation, Lender Liability and Deposit Insurance Protection Act of 1996 attempted to limit a lender's liabilities with commercial loans by defining the lines of demarcation between the roles of owner or operator and those with only security interest but no direct management participation.

Although this law filled some gaps left in earlier legislation, it did not provide an ironclad defense against potential post-foreclosure environmental-cleanup costs and penalties -- which can strain lenders and brokers.

For example, consider a scenario in which a major commercial bank had financed a light-industrial property with significant stocks of hazardous materials stored in onsite containers. Upon foreclosure, the borrower notified the lender that the sprinkler system needed winterization to prevent freeze damage.



The lender, already facing substantial costs and other issues, opted not to implement the winterizing process. The sprinkler system froze, inundating the contents, corroding many of the containers and eventually leaking chemicals into the groundwater. After a court case, the lender was forced to pay hundreds of millions in cleanup costs.

Prudent mortgage brokers and lenders should refocus risk-management approaches to address environmental issues adequately, especially in a climate of tighter lending guidelines and capital availability. Site assessments and environmental insurance can allow brokers to do this while still ensuring a profitable venture for their lenders.

Phase I surveys

Historically, lenders have called for Phase I environmental site assessments to evaluate the environmental risk on commercial property loans. This survey is a visual study designed to disclose to a prospective buyer the environmental risks associated with the purchase of commercial real estate.

This assessment's goal is to assure the borrower and lender that past environmental problems have not impaired a property in ways that might affect the value of collateral or result in post-foreclosure environmental liabilities.

Although Phase I site assessments can help identify the potential for environmental problems down the road, they alone do not provide indemnification for the lender against environmental costs that may appear in the wake of a foreclosure.

Beyond ensuring that the assessment occurs, brokers usually have little involvement beyond the status of interested observers. Typically, the lender will have a preferred consultant or a list of preferred survey-providers to perform the assessment. The lender normally requires the Phase I -- and sometimes a Phase II -- assessment, even though the borrower has to pay for it.

Costs for a typical Phase I survey usually begin at \$2,500 and can be as much as \$7,500, depending on the size of the property, type of occupancy, business processes and more. Environmental-consulting engineers perform these assessments and usually take several weeks to complete them.

Environmental-liability insurance

In the past 10 years, lenders also have been leveraging environmental risks with environmental-insurance vehicles, instead of simply trying to identify them at specific points in time. Insurance companies with specialized environmental experience offer these coverages. They can be underwritten for individual loans or for portfolios of new, commercial real estate-backed loans.

For single loans, lenders are using environmental insurance when there is a specific environmental concern on the property or on an adjacent property. This liability insurance can be used when a borrower

does not want to provide an environmental indemnity or escrow to the lender. In these cases, lenders may allow the borrower to purchase an environmental-insurance policy to benefit the lender only.

Lenders use this type of coverage for portfolios when they are looking to streamline their risk-management approach. Insurance companies can take as few as three business days to see if a loan meets their program criteria, and the cost for this coverage could be less than that of a new Phase I environmental site assessment.

Insurance is provided on a claims-made basis and remains in effect for the term of the loan. The borrower pays the premium as a part of the loan closing costs, assuming the loan closes. If a Phase I environmental site assessment is not required in the loan process, the loan also could close more quickly.

Although liability insurance alone cannot detect the environmental risks that a site assessment potentially turns up, it does have many benefits for lenders, including:

- **The ability to shield assets** by protecting collateral and with actual insurance coverage against environmental liability;
- **The potential for expediting loan-processing** and reducing costs; and
- **The opportunity to better manage cash flow** in the event of a claim.

Environmental-liability insurance can be another tool in a lender's portfolio of commercial real estate loan capabilities. It can provide minimal cost of coverage, speed when necessary and peace of mind for a broker.

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The potential complications that environmental issues create in the commercial loan process are a prime consideration during the qualification process. For brokers, detection of an environmental risk can kill a deal -- and the costs involved in a foreclosed-upon property with environmental issues can be a strain, as well.

It's helpful for all sides of the loan equation to remember the benefits that Phase I environmental site assessments and environmental-liability insurance can provide. They can be effective ways to manage risk and to provide greater assurance to everyone involved.



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