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In This Issue

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Simplfying Environmental Risk.

Appraisal Review Outsourcing Lessons for Environmental Risk

Lenders have been outsourcing commercial appraisal department functions for over a decade and the outsourcing model is being applied increasingly to Environmental Risk Management (ERM) services. Those who promote the benefits of outsourcing appraisal department functions often highlight the opportunity to realize cost savings, increase appraisal industry expertise, limit headcount, enhance compliance and allow the bank to focus on its core competencies.

Outsourcing ERM can provide many of those same benefits, particularly for banks that do not have an internal environmental department or for internal environmental departments in need of capacity building. But how similar are the two functions, and to what degree can lessons from the more mature appraisal industry be applied to ERM?

Clearly there are differences between the ERM function and the appraisal function. Perhaps the greatest difference is the degree of regulation and industry best practices. Unlike the appraisal review function, environmental risk was not specifically addressed in FIRREA or the 2010 Dodd-Frank Act. In addition, while there is regulatory guidance on the performance of Phase I Environmental Site Assessments, there is no standard on the review of those assessments within federally insured banks. While this provides more flexibility to the risk management departments, it also provides little guidance on best practices for ERM outsourcing.

There also are underlying differences between the appraisal and environmental review functions. The appraisal review function is critical to almost every real estate secured commercial loan, with the appraised value central to the underwriting process. By contrast, the environmental review is a key factor in the underwriting process only when there are issues identified by the reviewer. Although there is no reliable data on the percentage of loans that may be impacted, many attendees at the Environmental Bankers Association meeting in June of 2011 agreed that 5% to 15% of all commercial loans have material and identified environmental liabilities associated with collateral real estate.

Despite these differences, what lessons from the more mature (and regulated) appraisal industry can be applied to outsourced ERM? Although most of the regulations and commentary on outsourced appraisal department functions are focused on residential appraisals, many lessons are relevant to outsourcing ERM for commercial loans.

One of the greatest concerns about outsourced appraisal functions is appraisal quality. Some Appraisal Management Companies (AMCs), particularly those in the residential market and owned by non-appraisers, are widely seen as having pushed cost and speed at the expense of quality and competence. In many states, this issue is being addressed with regulations requiring that AMCs be owned, in varying percentages, by certified appraisers. To ensure quality, sophisticated banks seek to work with outsourced appraisal departments staffed with knowledgeable and seasoned appraisers.

When outsourcing ERM, it is likewise important to utilize ERM firms with significant experience working with banks on environmental risk. ERM is a specialty industry that requires a broad

Continued on Page 3

Court Cases Testing 2002 Brownfield Liability Protections

Brownfield developers and their lenders are keeping a close watch on court decisions regarding the All Appropriate Inquiry (AAI) standard of environmental due diligence. AAI is one of more than eight necessary components in establishing the "bona fide prospective purchaser" ("BFPP") defense established under the 2002 Brownfields amendments to the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"). The BFPP defense is intended to protect property owners from liability for contamination that occurred prior to their ownership. The intent of the BFPP defense was to provide liability protections to parties working in good faith to clean up and redevelop contaminated land; however, at least one recent decision has caused concern among developers and lenders.

In *Ashley II of Charleston LLC v. PCS Nitrogen Inc.* (D.S.C., No. 2:05-cv-2782, 9/30/10), Ashley purchased a contaminated site with a long history of industrial use. Ashley then sought to avoid liability for the cleanup costs through the BFPP defense. However, the court found that Ashley, a sophisticated brownfield developer, did not meet all of the various requirements to be considered a BFPP. As this was the most comprehensive assertion of the BFPP defense, its failure in court raised concerns about the protections afforded by the 2002 Brownfields legislation.

Despite Ashley's loss, the decision did provide some degree of comfort regarding the BFPP requirements for environmental due diligence. Although the court found that the environmental assessment reports prepared for Ashley did not strictly meet every aspect of AAI, the court found that Ashley still met the standard. Although Ashley did not meet other requirements of the BFPP defense, environmental risk managers were pleased that the court would accept environmental reports even though there were technical deficiencies.

Subsequent to the Ashley decision, the US district court in California found that a defendant had successfully utilized the BFPP defense. In 3000 E. Imperial, LLC v Robertshaw Controls Co, 2010 U.S. Dist. LEXIS 138661 (C.D. Cal. 12/29/10) the court found that the defendant satisfied the BFPP requirements despite some similarities to Ashley.

For lenders of brownfield redevelopments, it is important to note that establishing the BFPP defense may be more complex than many had hoped. While the performance of good due diligence reports may meet the standards for all appropriate inquiry, the courts may scrutinize whether the property owner met every other requirement of the BFPP defense. The fact that a sophisticated brownfield developer was unable to establish the BFPP defense (in Ashley) should make lenders careful when underwriting brownfield transactions. Brownfield developers and lenders will continue to look to the courts for guidance as more cases move forward.

For more information or questions on environmental due diligence, please contact us at 866.913.9738. ▪

New ASTM Standard for Large Sites

Lenders and environmental risk managers have started to see reports prepared to the new ASTM (AmericanSociety for Testing and Materials) standard E 2247-08 "Phase I Environmental Site AssessmentProcess for Forestland or Rural Property." The standard was tailored to Phase I Environmental Site Assessments (ESAs) on forestland or rural properties measuring 120 acres or more, although applicable properties may contain isolated non-forest and non-rural areas. The standard is designed to constitute "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice" as defined in environmental statute (42 U.S.C. §9601(35)(B)).

As with a Phase I ESA conducted to ASTM Standard E 1527-05, ASTM Standard E 2247-08 consists of four components: a records review, a site reconnaissance, interviews and a report. However, the 2247 standard allows for the use of aerial and satellite photographs to assist with the inspection of the property when necessary. The environmental consultant may utilize the photographs to identify structures and areas of concern before physically inspecting those areas. In addition, if the property cannot be accessed, there are provisions for other inspection methods such as viewing the property from adjacent public thorough-fares.

The ASTM E 2247-08 requirements for regulatory records and historical information are also modified from the E1527-05 standard. Instead of requiring a radius search associated with the regulatory database report, ASTM E 2247-08 uses an Approximate Minimum Search Distance that effectively incorporates the individual database radii into a property boundary buffer. Historic information sources can include newspaper archives and miscellaneous maps such as those created for mining and forestry management.

The requirements for report content and detail in the E2247-08 standard are similar to those in the E 1527 standard; however, ASTM E 2247 offers the consultant conducting the assessment more flexibility. This flexibility appears to be a major advantage of ASTM E 2247. For borrowers or lenders and environmental risk managers, this flexibility may add another layer of complexity to the review and property evaluation of environmental assessments.

For more information or questions on Phase I Enviromental Site Assessments and the new ASTM Standard, please contact us at 866.913.9738. ▪

Appraisal Review Outsourcing Lessons for Environmental Risk (continued from cover)

background in environmental geology, environmental and financial regulations, and insurance and underwriting. Law firms should be engaged when complex legal issues are identified and consulting firms can be engaged to provide guidance on specific technical concerns. However, the ERM function requires an experienced and balanced approach to ensure appropriate underwriting support.

A second lesson from the appraisal industry applicable to ERM is the importance of eliminating conflicts of interest. The desire to eliminate conflicts – often referred to as "transparency" in the appraisal industry – is a major reason for the increased use of outsourced appraisal department functions, and a significant amount of regulation and commentary has focused on the prevention of conflicts. Preventing conflicts is likewise important in outsourcing ERM. An ERM firm should never maintain a financial interest in its recommendations. For example, it would be inappropriate for an ERM firm to recommend additional Phase II services in a situation where they are guaranteed to get the work and competitive bids are not allowed.

Regulations prevent borrowers and loan production staff from involvement with the appraiser selection and limit the information that can be shared with the appraiser. These policies clash somewhat with best practices for ERM. For various liability reasons, there are times when it is best for an environmental assessment to be ordered by the borrower, such as when the borrower is purchasing a site and is performing their own due diligence. In addition, the ERM firm may need to discuss the specifics of a transaction with a lender in order to determine whether an identified concern is material. That said, it is important that the choice of the ERM firm is not determined by the individual lending groups. If more than one outside ERM firm is available to the lending groups, the lenders may choose over time to send ERM work to the firm that is most "deal friendly."

Outsourcing environmental and appraisal department functions can provide many benefits to the lender including lower costs, increased expertise, lower headcount, and enhanced compliance. However, it is important that these functions are outsourced appropriately and with transparency. Working with firms with a focus on excellence and integrity is critical in successfully implementing an effective and prudent outsourced model. Done well, outsourcing the appraisal and environmental department functions can allow a bank to concentrate on its core competencies while realizing cost savings, flexibility, and improved risk management.

For more information regarding appraisal review and environmental risk management outsourcing, please contact us at 866.913.9738. ▪

EPA Study Finds Phase I's Deficient

A recent report from the USEPA Office of Inspector General highlights the problem of environmental assessment quality. The report summarizes the review of 35 environmental site assessments that were submitted to the USEPA's Office of Brownfields and Land Revitalization to receive federal grants. Of the 35 reports, which were to adhere to federal "All Appropriate Inquiry" (AAI) standards for environmental site assessments, none met the AAI standards. The AAI standards form the basis for the ASTM E-1527-05 standard for Phase I Environmental Site assessments.

For those who review Phase I ESAs for lenders, these results are not surprising; Phase I ESAs often contain technical deviations from the ASTM standard. Still, the pervasive extent of the deficiencies presents three potential consequences for lenders. First, the results of the study confirm the importance of utilizing environmental consultants that have the experience to accurately comply with the ASTM Phase I requirements. This is especially important for foreclosure sites and other situations where the bank may seek to qualify for environmental liability protections through the performance of AAI.

Second, banks that require strict adherence to ASTM standards as part of their credit policy could create unrealistic expectations and additional costs for pre-lending due diligence. Ensuring strict compliance to the standard could significantly add costs and increase the demands on the review staff without necessarily providing a corresponding enhancement to risk identification.

Third, the report notes that if conditions merit, the EPA can take back funds, withhold future payments, or disallow certain cost activities for noncompliant grantees. As a result, Phase I ESAs that do not meet AAI standards could add additional risk to projects that assume government grants.

The Office of Inspector General concluded that the deficient assessments increase the risk that environmental conditions were not adequately assessed and threats to human health and the environment went unrecognized. While this is a reasonable conclusion, the degree to which the deficiencies in the reports resulted in missed environmental liabilities was not addressed. Indeed, many of the noted deficiencies are technical in nature and may not fundamentally change the conclusions of the assessments.

While concerns over compliance with ASTM standards do not necessarily mean that Phase I ESAs are missing significant environmental liabilities, Lenders are well served by evaluating how these deficiencies may impact their environmental risk profile.

For more information or questions on Phase I Environmental Site Assessments, please contact us at 866.913.9738. ▪

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ABOUT US

ERI is the nation's premier environmental risk management consulting firm, specializing in risk management services for commercial lenders. ERI's environmental risk professionals all have extensive experience in the area of commercial lending. Our expertise in the evaluation of environmental risk uniquely qualifies us to assist lenders in the development of environmental policies that are custom tailored to the risk tolerances of our client banks. ERI understands that due diligence and risk mitigation is just one small, but important element of real estate transactions. ERI is familiar with the critical deadlines that loan officers face and our professionals are experienced in supplying high quality, rapid response due diligence to meet these deadlines. ERI prides itself on customer service and flexibility to match each customer's specific needs. Outsourcing environmental risk management services to ERI allows our clients to focus on their core competencies and primary business objectives surrounding the successful execution of commercial loans.

Contact Us Today! 866.913.9738

ERI Announces Alliance with LaSalle Commercial Appraisal Management

ERI, LLC announces an alliance with LaSalle Commercial Appraisal Management (L-CAM), one of the nation's most experienced and respected commercial appraisal review firms. All of L-CAM's review appraisers have at least 25 years of experience in the field of commercial property appraisal and commercial property appraisal review.

In addition to providing appraisal review services, L-CAM provides consulting services to banks on appraisal compliance, appraisal policy development and appraisal ordering and review procedures. ERI and L-CAM work together to provide the nation's leading alliance in outsourced appraisal and environmental review services for commercial lenders.

For more information on the turn-key services offered by ERI and L-CAM, please contact us at 866.913.9738. ▪

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