Environmental Due Diligence in Real Estate Transactions
Identifying and Mitigating Risks and Liabilities for Buyers, Sellers and Lenders

THURSDAY, JANUARY 10, 2013
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Today’s faculty features:

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Derek Ezovski, President, Outsourced Risk Management Solutions, West Hartford, Conn.
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Environmental Due Diligence

Assess potential for liability/costs to arise under Environmental Law

Cindy J. Karlson, Esq.
Agenda

- Overview of Environmental Due Diligence
- Considerations for:
  - Sellers
  - Buyers
  - Lenders/CMBS
- Questions
Framework for Environmental Due Diligence

Compliance with Environmental Laws

- Common Law Issues
- Statutory Obligations

Evaluate Potential for Liability under Regulatory Regimes

- CERCLA, RCRA, Clean Air Act, Clean Water Act, state analogs
- CERCLA Issues
  - Site nexus will be established with transaction
  - Assess Liabilities and possible defenses
  - Defenses – very limited
  - Innocent landowner defense
  - Bona fide prospective purchaser defense
  - Contiguous landowner defense
Transactional Considerations

Stock Acquisition

Company transitioning unchanged

Corporate liabilities of company unchanged by transition

Asset Acquisition

Liabilities arise only as related to the assets transitioning

Contamination present, contamination originating from, and current compliance status of the asset(s)

<table>
<thead>
<tr>
<th>Risk</th>
<th>Stock Acquisition</th>
<th>Asset Acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Site Condition</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Off-Site Conditions - Migration</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Off-Site Conditions- Transportation</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Other Sites (e.g., Formerly Owned)</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Compliance History – Current</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Compliance History – Past</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>
Due Diligence Strategy Considerations

- **All Appropriate Inquiry**
  - Primary function – Support CERCLA defenses
  - Evolved into de facto commercial standard – ASTM – 1527-05
  - Specific elements required
  - Still responsible for any new conditions on the Site

- **Operational Compliance**
  - Permits
    - Violations?
    - Transferrable?
  - Equipment
    - Age/maintenance
    - Transfer of warranties

- **Common Law Compliance**
  - Contractually required disclosures
  - SEC disclosure review
Due Consequences for Cutting Corners

- **Litigation**
  - Be able to demonstrate that appropriate due diligence was performed
  - Malpractice recourse
  - Avoid “fire fights” over unforeseen costs and liabilities not accounted for in transaction terms and contracts

- **Recent Case Law**
Environmental Due Diligence: Considerations for Sellers

Presented by:

Cindy J. Karlson
January 10, 2013
Due Diligence Competing Strategies

Buyer’s Goal:

Balance the cost and schedule of due diligence to achieve reasonably predictive levels of data/information

Seller’s Goal:

Retain minimal, if any, liability for environmental conditions while obtaining the maximum selling price with the least possible out-of-pocket costs
Seller’s Transactional Goals

- **Sell Site “As Is”**
  - Maximum possible price (minimize price impact associated with pollution)
  - Maximum releases from Buyer
  - Maximum indemnity/protections
  - Environmental insurance options

- **Considerations**
  - Assure that walk-away is complete
    - Clean-up is completed to satisfaction of regulators
      - Before or after transaction?
      - Who will perform?
    - Prohibit uses contrary to final Site condition
    - Assure maintenance of engineering/institutional controls
Assemble The Right People For The Job

- **Environmental Deal Team**
  - Internal – Data review
    - EHS Director
    - Plant Manager(s)
    - In-House Counsel
    - Knowledge Basis – Senior Managers/Officers, Current (not former) Employees
  - External
    - Environmental Counsel
    - Environmental Consultant
    - Insurance Broker – with Specific Environmental Expertise

- **Define Assets**
  - Stock or Asset Sale?
    - All assets?
    - Former owned/operated assets?
A Best Offense Is A Good Defense For Sellers

- Collect and Organize Available Data
  - Prepare the universe of data and information – Lack of data is a Purchaser risk $$
    - Technical
    - Legal
  - Control the information process
    - Limited Access – Secure website or central location
    - Full Access – Hard copies, CDs
  - Compile Data
    - Complete
      - Withholding data/information limits/vitiates contractual protections
      - Disclosure Obligations – By state and by contract
    - Final reports/data
    - Permits
    - Information on equipment/facilities
    - Term – How far back ??
  - Data Gaps Identified
    - Potentially material?
    - Benefit analysis – Self-perform or accept risk-based price reduction?
Establish Level of Materiality

- Permits, Notice of Violations, Agency Correspondence
- Review of Existing Phase I and Phase II Reports
- On-Going Site Remediation?
- Potential Responsibility Party Notices/Obligations
- Pending or Threatened Litigation?
- Prior Owned Sites—Any Legacy Liabilities?
- EH&S Legal/Administrative Actions
- Ongoing Indemnity Responsibilities
- Expected Capital Expenditure Costs
- Estimated Environmental Reserves
- Air Compliance/New MACT Standard
- Worker Health and Safety Record
AAI, EMS and Self Audits

- **All Appropriate Inquiry Considerations**
  - Self perform
  - Confidentiality - Consider and Control
    - Current and past employees/owners, Neighbors, Regulators
  - Assess Identified Data Gaps – Benefit Analysis
  - Anticipate Limitations
    - Lead-based paint, Asbestos, PCBs, Health/Safety, Wetlands
  - Get reports in DRAFT – to Counsel
  - Property Condition Assessments?

- **Environmental Management System and Self Audits**
  - Is your house in order?
  - What if I discover noncompliance issue as I perform defensive due diligence?
Playing By The Rules: Control The Process

- **Confidentiality Agreements**
  - Basic protections
  - Expressly limit and define regulatory interactions
  - Include non-solicitation provisions

- **Regulatory Access for Purchaser**
  - Personal visits - Not recommended
    - Alert regulators to change – increase regulatory interest
    - Potential for issues to identified/raised to regulators
  - File Reviews – Limit
    - Significant activity on a file – increase regulatory interest
    - Potential to allow if limited to single (final) Purchaser

- **Final phase/negotiations**
  - Purchaser may want/need regulatory access to negotiate protections
    - Never allow Purchaser access to regulator without Seller present
    - Maintain role in any regulatory protections negotiations – DEAL CAN CRATER
Site Access?

Control/Oversee Visits
- Prepare site overview for potential purchasers
- Consider how to take questions and supply answers
- Will photographs be allowed?
- Limit number of people buyer is allowed to have during the visit

Forbid/Limit Site sampling by purchasers
- NOT RECOMMENDED
- Could trigger reporting requirements for seller
- Split samples
Potential Ramifications for Non-Disclosure

**Liability**
- Audit opinion disclosure
- Depending on the state, incur strict liability

**Contractual**
- Default provisions for breach of representations and warranties
- Termination of deal

**Insurance Coverage**
- Jeopardize or limit coverage
- Policy cancellation
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Environmental Due Diligence Considerations for Buyers

Rachel M. Rosen, LEP
Buyer’s Due Diligence

* Developing a Due Diligence Strategy
* Liability Protections Available and Qualifying for Those Protections
* The Findings: Potential Risks Presented by the Assets
* Related Topics & Considerations
* Selecting Consultants & Counsel
Tips For Due Diligence Strategy

* What is necessary vs. recommended
* All Appropriate Inquiry & ASTM E1527-05
  - What is included?
  - What is not included?
* Potable water, mold, asbestos, wetlands, lead-based paint and indoor air quality

Appreciate the factors that guide various lenders and your own liability tolerance
Developing A Due Diligence Strategy: Buyer’s Perspective

* **Transactional Factors**
  - Size of the deal vs. nature and extent of Buyer’s due diligence efforts
  - Buyer’s risk tolerance
  - Financing conditions
    - Commercial lender, private equity issues
  - Schedule constraints
    - Buyer does not have to compromise on due diligence even under tight timeframes (i.e., e-due diligence rooms can be accessed 24/7)
  - Budget limitations

* **Corporate Governance**
  - Fiduciary duties
Liability Protection For Buyers

* 2002 SARA and the Small Business Liability Relief & Revitalization Act (Brownfield Amendment)
  - Innocent landowner defense
  - Bona fide purchaser defense
  - Contiguous landowner defense

* What work is required to qualify for liability protections
  - All Appropriate Inquiry
    - 42 U.S.C. § 9601(35)(B)
    - 40 C.F.R. 312 (2005)
All Appropriate Inquiry

* Regulatory Considerations - All Appropriate Inquiries

- Eligible persons for liability protection under CERCLA
  - Innocent landowners, contiguous property owners
  - Bona fide prospective purchasers
  - State or local government that acquire ownership/control involuntarily through bankruptcy, tax delinquency or abandonment

- Conditions to satisfy AAI:
  - Must perform due diligence in accordance with 40 CFR Part 312
  - AAI timelines prior to acquiring ownership of property:
    - Within 1 year prior to acquisition, perform or update AAI
    - Within 180 days prior to acquisition, perform interviews of current and past owners; review government records; on-site visual inspection and search for environmental cleanup liens
AAI alone does not guarantee CERCLA protection, the following conditions must also be met:

- Comply with Continuing Obligations after acquiring the property
  - Provide all legally required notices with regard to discovery of releases of hazardous substances
  - Comply with land use restrictions, fully cooperate with persons conducting response actions and information requests; use due care with respect to hazardous substances
- Buyer must not be affiliated with any liable party through family, contractual, corporate or financial relationship (other than the property conveyance instrument)
Presence or likely presence of any hazardous substances or petroleum products on a property under conditions that indicate an existing release, a past release, or a material threat of a release of any hazardous substances or petroleum products into structures on the Site or into the ground, ground water, or surface water of a property. The term includes hazardous substances or petroleum products even under conditions in compliance with laws. The term is not intended to include de minimis conditions that generally do not present a material risk of harm to public health or the environment and that generally would not be the subject of an enforcement action if brought to the attention of appropriate governmental agencies.
* Varying interpretations
* No RECs = Clean Site
* Examples
  - Not all releases are reported
  - Some underground storage tanks
  - Some process lines
* Read Your Report!

* Does the “Story” Make Sense?

* Know Why Due Diligence was Performed
  - Real Estate Transfer?
  - Funding/Insurance?
  - Regulatory Program?
  - Example – Dry Cleaner - Strip Mall
Read Between The Lines

* **Potential “buried” risks in due diligence findings:**
  - Scrutinize waste disposal practices – no matter how small the quantity of waste
  - Understand implications of water use/availability for your site and development plans
* **Evaluate status of regulatory permits** (any permit transfers necessary?)
* **Identify potential risks** related to adjacent properties
Deal Specific Interpretations

* Are there other factors that impact the findings?
* Did they miss something key to the non-environmental part of the deal?
* Examples
  - Redevelopment Site – Urban Fill [aka Historical Fill]
  - Example – Manufacturer on Former Agricultural Land
Related Topics & Considerations

* Reliance Letters
* New(er) Topics on the Scene
* Vapor Intrusion
* Building Energy Performance Assessments
Reliance Letters

* Not A Given
* Not a Guarantee of Buyer Protection
* Text Varies Widely
* Tied to Other Contracts
* Conflicting Obligations
New On The Scene

* Potable water
* Indoor air
* Vapor intrusion
* PCB in caulk
* Property Condition Assessments (ASTM Standard E 2018)
* Building Energy Performance Assessments (BEPA)
* Continuing Obligations (ASTM Standard E2790-11)
Vapor Intrusion

* Migration of volatile chemicals from the subsurface into buildings

* Potential liability exposure
  - Tenant and third party claims
  - The CERCLA definition of “release” includes vapor intrusion
  - Continuing obligations at site
New ASTM standard: Standard Practice for Building Involved in a Real Estate Transaction

It is a tool to calculate a building’s energy consumption and cost – different from an energy audit

Can be used for disclosure to an interested party

Intended to supplement ASTM E 2018 and E 1527 environmental site assessments

Consultant may offer bundle pricing for ESA, PCA and BEPA
Selecting Consultants & Counsel

* Evaluate consultant and/or attorney’s experience and credibility with government agencies
* Evaluate the business acumen and negotiation skills of the key individuals (you want a strong person in your corner supporting you in post-due diligence negotiations)
* Scrutinize the scope of work (the devil is in the details)
* Carefully review the consultant’s terms and conditions to the contract
* You get what you pay for in most cases
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Environmental Due Diligence in Real Estate Transactions

Environmental Trends in the Lending Community

Presented by:

Derek Ezovski

January 10, 2013
Current Trends in Lending

• Pressure from regulators

• Need to shore up balance sheets

• SBA Lending

• Lenders beginning to increase their commercial lending, specifically for commercial real estate

• Lenders updating environmental/appraisal policies

• More levels/forms of due diligence than ever before on more loans
Current Status of Banking

- Bank closures have been occurring since 2007, most of which had unusually high commercial-mortgage exposure.

- 2006 - 0
- 2007 - 4
- 2008 - 25
- 2009 - 140
- 2010 - 157
- 2011 - 92
- 2012 - 53

- EBA Survey - 63% of lenders that had an examination over the last couple of years were asked about their environmental policy.
CRE Lending

• While increasing bank leniency and improved fundamentals have helped revive the CRE market, the high level of maturing debt remains a significant barrier to recovery.

• However, lenders’ focus on permanent loan resolutions through pre-foreclosure sales will likely provide opportunities for investors to acquire overleveraged properties at attractive prices.

- excerpt from Deloitte CRE Study
CRE Defaults Increasing

Figure 27: Delinquent, Defaulted, and Non-Performing Commercial Real Estate Loans for All Domestic Commercial Banks

Legend:
- Loans 30-89 days Past Due
- Loans 90 days or More Past Due
- Loans in Nonaccrual Status
Day of Reckoning

The number of commercial real estate loans due, and the portion that are underwater, will grow over the next few years.

$250 billion

Loan-to-value more than 100% (Right scale)

Total amount maturing (Left scale)

Source: Foresight Analytics
Commercial Mortgage Maturities

Source: Foresight Analytics
CMBS Maturities

Maturity profile of fixed rate commercial mortgages in CMBS transactions

Loan Vintage

Balance of Maturing Loans ($bn)

Source: Deutsche Bank, Intex, Trepp
At least $1.7 trillion of CRE debt will mature between 2012 and 2016. Trepp LLC estimates that nearly 29.0 percent of these loans are underwater, which continues to pose a risk to a broader CRE recovery.
Rising Demand Triggers Higher Volume

Spread between benchmark yields from new CMBS issues and interest-rate swap rates

- 2.5 percentage points
- 2.0
- 1.5
- 1.0
- 0.5
- 0

Volume of commercial real estate loans converted into CMBS and sold to debt investors

- $250 billion
- $30.8 billion

Source: Commercial Mortgage Alert
The Wall Street Journal

*Year to date 2012 issuance includes a $1.1 billion J.P. Morgan offering scheduled to price this week.
Issues Important to Lenders

- Credit & Trust Risk
- Collateral Devaluation
- Direct Liability - Loan origination to foreclosure
- Reputational Risk (Brand and Image)
- Operational & Enterprise Risk

...but at the end of the day, the primary issue for lenders is *Business Risk*
Regulation Changes on the Environmental Front

- AAI rule in effect
- FDIC makes first update to environmental policy guidance in 13 years, recognizes AAI as option
- March 2008 FDIC Chair reaffirms need to manage portfolios closely
- SBA SOP 50-10 (5) Effective
- SBA adopts AAI for all Phase I ESAs
- FDIC, OCC, Fed issue joint guidance, urge banks to implement tougher standards for CRE lending
- NCUA releases guidance for environmental risk management program
- SBA SOP 50-10-5 (A) Update is Released
How Did AAI Affect Lenders

• For the first time, there was a federal statutory authority saying what is needed for a Phase I environmental site assessment

• Biggest impact of AAI on lenders were the changes to regulatory and government agencies - specifically FDIC guidelines and the Small Business Administration
“New” FDIC Guidance

• FDIC updated its Guidelines in November 2006.

• NCUA updated their guidelines and issued guidance in May 2008.

• FDIC’s guidance set the standard; FDIC is regarded as a leader in terms of environmental requirements.

• FFIEC implemented environmental policy training/education for examiners across all agencies (October 2007, May and June 2008)

• A majority of lenders have reconsidered and revised their environmental policies.
NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: May 2008  LETTER NO.: 08-CU-13

TO: Federally Insured Credit Unions

SUBJ: Environmental Liability: Risk Management Guidance

ENCL: (1) Appendix A – Guidance for an Environmental Risk Management Program
      (2) Appendix B – List of Resources

Dear Board of Directors:

The purpose of this letter is to inform all federally insured credit unions of potential liability to your members, and possibly to the credit union, when environmental contamination is discovered on real property financed by the credit union. While environmental liability can occur with any real estate secured loan, it is generally more likely to occur with non-residential real estate (i.e., commercial use properties). All credit unions granting real estate secured loans need to be aware of this issue and credit unions granting member business loans secured by real estate should establish policies and procedures to help ensure liability in this regard is minimized.
FDIC Focus

– FDIC emphasize process and consistency.
– Training
– Policies and Procedures should be established;
– Environmental Risk Analysis should be conducted;
– Document due diligence;
– Track changes to policy and consistent application of policy.
– Monitoring
– Lenders must avoid “participating in management” of the business and thereby assuming liability under CERCLA.
– Most attorneys recommend a Phase I ESA in the event of foreclosure.
Small Business Administration Update

- SBA updated its Environmental Policy
- Effective August 1, 2008 and updated five times since (most recently in June 2012).
- Went from 1000 pages to 400 pages.
- Especially important for institutions with preferred status who do SBA underwriting.
- 7A and 504 lenders must adhere to this policy.
- Has become default policy for many lenders.
SBA Environmental Due Diligence Policy

2 levels of Environmental Due Diligence for SBA

1. Phase I - for high risk properties
   - If property type/use matches the list of NAICS codes for Environmentally Sensitive Conditions

2. Records Search with Risk Assessment - low risk properties
   - Includes a search of the government databases (compliant with AAI);
   - A search of historical use records, and;
   - A risk assessment by an environmental professional determining whether the site is “High”, “Elevated” or “Low” risk

- New Gas Station/Dry Cleaner Requirements
## Sample SBA Policy Matrix

<table>
<thead>
<tr>
<th>Real Estate Loan Type</th>
<th>Minimum Due Diligence Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&lt;$150K</td>
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<tr>
<td><strong>Low Risk Loans</strong></td>
<td>Questionnaire</td>
</tr>
<tr>
<td><em><em>High Risk</em> Loans – NAICS Codes</em>*</td>
<td>Phase I</td>
</tr>
<tr>
<td><strong>Gas Station</strong></td>
<td>Phase I + Evidence of UST Compliance</td>
</tr>
<tr>
<td><strong>Dry Cleaners</strong></td>
<td>Phase I</td>
</tr>
<tr>
<td><strong>Dry Cleaner (older than 5 years old)</strong></td>
<td>Phase I and Phase II</td>
</tr>
<tr>
<td><strong>Special Use Facilities (i.e. Daycare)</strong></td>
<td>More specific requirements (i.e. Lead Paint Testing, Lead in Drinking Water, etc)</td>
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Impact of Lender Size/Resources

Regional & National Lenders

- Resources in place to understand environmental issues on the property
  - Screen for lower-risk loans
  - Have staff/internal resources to manage environmental risk

Credit Unions/Community Banks

- No on-staff environmental expertise (typically)
- Not as sophisticated with regard to environmental issues or due diligence options available
- Often rely only on environmental questionnaires and/or proceed without accurate knowledge of environmental condition of property
- Rely on external guidance to dictate their practices
Trends from EBA Survey of National Banks

- Less “Command and Control” by ERM departments
- More flexible than in the past;
- More time going into reviewing reports provided by the borrowers vs. bank commissioned reports.
- Slow adoption of sustainability and “green” programs
  – High default rates/foreclosures might be contributing
- Very consistent with past practices
- Continue to outpace credit unions/community banks in risk management
Tiered Due Diligence

• 61% of lenders stated they had added more levels of due diligence over the past 2 years.

• 51% of lenders said they would adopt the SBA policy for their traditional loans as well.
Environmental Due Diligence Options

- Environmental questionnaire (EQ)
- Desktop due diligence
- Transaction Screen Assessment (TSA)
- Phase I Environmental Site Assessments
- Phase II, III, Remediation, etc.
- Environmental insurance
- Stormwater Issues
- Sustainability/Green Issues
- *Environmental Insurance*
- Others
Common Commercial Issues

- USTs
- Fuel Oil Tanks
- Spills
- Storage/disposal of Hazardous Waste
- Vapor Intrusion
- Gas Stations
- Dry Cleaners
- Mold, lead, asbestos, radon, etc.
- Stormwater Runoff
- Superfund
Examples of Environmental Concerns for Lenders

1. Foreclosures

2. “Boring” property that used to be auto shop...

3. Retail that used to be Gas Station

4. Removal of waste from a property by lender triggers possible action
What the seller sees...
What the buyer/lender should see...
Summary

• Lenders have unique processes and reasons for conducting due diligence.

• Market pressures have reinforced long-term trend to increased due diligence.

• Regulators enforcing risk management due to a perceived over-concentration of risk regarding commercial real estate.

• Risk Management (Credit, Collateral, Environmental, etc.) is as critical as ever to lenders.

• Environmental and appraisals are both pieces of the puzzle that are being revised under the current environment.
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