

## **Environmental Risk Assessment during Workout and Foreclosure Of Commercial Properties**

Foreclosure on a commercial property requires informed decision making after carefully coordinated environmental due diligence. A lender must be careful to not interfere with the business of the Borrower and the Borrower's right to quiet possession of the collateral property during the term of the loan and redemption period. However, the lender must also be aware of the potential for collateral related environmental concerns that might result in a diminution in the value of the collateral or create liability for the lender once the lender takes title or possession of the property.

For all loans, the initial step is to review the environmental assessment that was performed prior to making the loan. The workout officer should not be surprised to find that the pre-loan due diligence did not rise to the level of a Phase I environmental site assessment (ESA). Since the lender will become owner of the property upon foreclosure, a full Phase I should be the standard prior to beginning the foreclosure process. Anything less will be an exception to policy.

Timing of the pre-foreclosure environmental due diligence can be tricky. It is best to perform the Phase I ESA when it first appears that the loan may be in jeopardy and when the Borrower is still cooperative. Once the loan relationship has soured, it may not be possible for the environmental consultant to gain access to the property.

In many situations, such as the case with industrial properties, the inability to gain access to the property may preclude performance of a competent Phase I. There are types of property, however, where no chemicals are in use, and where the access to the interior of a building may not be fatally detrimental to the competence of the Phase I.

If it reveals no issues, a Phase I ESA should protect the lender by means of the innocent landowner defense to cleanup liability. Failure to complete a Phase I, however, will likely result in the loss of the innocent landowner defense. If the Phase I does reveal potential environmental issues, the lender may have pause to reconsider the property value and the wisdom of foreclosure. In some situations, it may also be appropriate for the lender to obtain a Phase II ESA. Phase II ESA work generally includes intrusive sampling. In addition, the lender should consider environmental issues that do not fall under the purview of a Phase I, such as asbestos, lead based paint, wetlands and radon.

Following the Sheriff's sale, it is also unlikely that the environmental consultant will have access to the collateral property. Like many states, Michigan has created a statutory redemption right following judicial foreclosures and foreclosures by advertisement. The right currently is a six month right in most cases (the redemption period can be as little as 30 days or as long as one year.)

If the lender takes title at the Sheriff's sale, the question arises as to whether the lender can still gain the protections of the innocent landowner defense to liability for cleanup of any site contamination. The general State and Federal rule is that the innocent landowner defense must be obtained prior to taking title or possession, whichever is earlier.

Under the Michigan Natural Resources and Environmental Protection Act (the "Act"), a new owner (the lender in this case) can avoid liability for cleanup of pre-existing contamination by performing all appropriate inquiry (a Phase I ESA) at the time of (i.e. prior to) acquisition. The Act also provides that if the lender has not been able to do a Phase I ESA because full access to the property was denied by the Borrower, even though the innocent landowner defense may be lost, there may be a second chance to avoid liability by means of conducting the Baseline Environmental Assessment (BEA).

The Act states that an owner is not liable for cleanup of pre-existing contamination if the owner conducts a baseline environmental assessment prior to or within 45 days after the earlier of the date of purchase (the sheriff's sale or taking a deed in lieu), occupancy or foreclosure. Under the provisions of the Act, "foreclosure" means possession of a property by a lender on which it has foreclosed on a security interest or the expiration of a lawful redemption period, whichever occurs first.

The Michigan Department of Environmental Quality's "Instructions for Preparing and Disclosing Baseline Environmental Assessments and Section 7a Compliance Analyses", while neither statute nor rule, state that "in situations where a foreclosing lender is delayed in getting access to a property because of the foreclosure redemption process, the 45 day period will begin when the lender gains control over the property. The lender must fully document any delays attributable to the redemption process."

## Summary

To minimize the risk of environmental liability, a lender should consider the following guidelines during the workout and foreclosure process:

1. The initial step is to review the environmental assessment (if any) that was performed prior to making the loan.
2. Next, sit down with an environmental professional to create a course of action. There may be situations where it becomes clear that the lender does not want to foreclose at all.
3. In most situations, attempt to get the Borrower's permission to access the property for a Phase I ESA.
4. If this cannot be competently accomplished during the life of the loan, and access cannot be gained during the redemption period, it is critical to document the attempts made by the lender to gain access for environmental due diligence.
5. At the end of the redemption period, it is important to start the Phase I ESA immediately. If necessary, the Phase I, Phase II and BEA must be conducted within 45 days of the end of the redemption period. This is an extremely compressed period of time for these three actions to be performed.

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