

## CONSIDERING FORECLOSURE?

YEOMAN GROUP routinely has requests for guidance from lenders regarding foreclosure. The following represents common questions and concerns when looking at foreclosing on a property. For additional information please see the article titled “Foreclosure Timing” found in the available Yeoman Group articles for download.

1. Why is pre-foreclosure environmental due diligence so important, especially for community banks and credit unions?

Upon foreclosure the lender becomes the owner and is liable for cleanup of any contamination on the property unless the lender takes appropriate steps to protect themselves. Even if shortly after foreclosure they sell the property, they remain in the chain of title and are often seen as the “deep pocket” easy target for cleanup response. If they foreclose without due diligence and unknowingly take title to contaminated property, they may face a large financial loss. Large banks often have large loan loss reserve funds to cover these situations and can take significant hits. Smaller lenders may not be able to withstand much in the way of loss.

2. Is a full Phase I always necessary, or can the lender get away with less?

Only a Phase I renders any legal protection. A lender would be hard pressed to explain a subsequent loss to their shareholders if they did not perform a Phase I prior to foreclosure. However, in all reality, an ASTM transaction screen or another “smart look” at the property that targets the realistic environmental threats to that type of property may render the same valuable information as a Phase I. It is the lender’s choice.

3. How should a Phase I conducted pre-foreclosure differ from a Phase I conducted pre-purchase?

The content of the Phase I is the same. The procedures may be more difficult in that there is often an adversarial relationship with the site owner – making site visit and owner and tenant interviews sometimes impossible. Therefore, it is best to start the Phase I as soon as it appears that the loan may be in jeopardy and before tensions rise.

4. Does a pre-foreclosure Phase I cost more than a traditional Phase I?

Generally Phase I’s are lump-sum contracts with the consultant and the prices are the same, although the pre-foreclosure Phase I may be more difficult for the consultant because the owner may not be cooperative.

5. What “non-scope” items should be included and why?

Non-scope items are those environmental concerns that are not addressed by a Phase I. These items correspond to the specific property type. For example, asbestos- containing materials, lead-based paint and mold are very important for multi-family properties – both pre-loan and

pre-foreclosure. If a proper Phase I was preformed pre-loan, then some of the non-scope items should have been resolved and would not be needed pre-foreclosure.

6. When should pre-foreclosure due diligence be conducted?

As soon as the lender sees that a loan is in potential trouble. By the time a fight begins between lender and borrower, the Phase I becomes more difficult. In some situations, the borrower prevents access to the property prior to Sheriff's sale and during the following redemption period. In these situations, the Phase I may have to be conducted with severe limitations. A Phase I conducted after the end of the redemption period may not provide any legal protection to the lender.

7. Are small lenders generally aware of what might trigger the loss of secured creditor exemptions?

No. This area of the law is very obscure. Small banks and credit unions are generally aware that, as a mere secured creditor, they are not liable to cleanup contamination on the collateral property. However, they are often unaware of how their secured creditor protections may be lost. In addition, they often believe that if due diligence was done pre-loan, then nothing else is required prior to foreclosure. (Much too often, they turn to free advice from environmental consultants and engineers and therefore do not get valuable professional legal advice.)

8. Do Phase I results typically change lenders' foreclosure decisions? If so, how?

Yes. In today's environment, the value of the secured property may be near or less than the outstanding balance of the mortgage. Lenders have to think carefully about the costs that will be incurred due to foreclosure and the expected recovery upon sale of the property. Often, when a Phase I reveals for the first time that the property is contaminated, and therefore of less value than previously thought, a lender will forego foreclosure and pursue other possible avenues to retrieve the balance of the loan.

9. Do community lenders handle pre-foreclosure due diligence differently than big banks do?

Lenders, whether large or small, are all over the board on how they proceed with environmental due diligence prior to foreclosure. There is just no consistency. A conservative lender will always obtain a Phase I prior to foreclosure on a commercial property.

10. What can be done to resolve site access issues? What if the consultant can't get access?

This is a question that I would like to explore. Most attorneys indicate that the lender and consultant should not do site reconnaissance without the permission of the borrower. Vague questions of trespass and interference with business are thrown about. However, the mortgage documents generally specifically allow the lender to visit the property during business hours for these purposes. It is likely that, if the site visit does not interfere with business, the site visit is lawful. In addition, it may be possible to get a court order to perform the site visit, even accompanied by a marshal if necessary. In most real world situations, if the consultant cannot

get site access, they visit the surrounding properties and view the property from off-site, use aerial photographs and document the failure to visit in their report as a limitation. They then have to render an opinion as to the effect of that limitation.

11. Anything else community lenders should know about pre-foreclosure environmental due diligence?

Keep in mind that the Phase I may only be the first required step and that expensive Phase II soil borings and other work may be required before there is an appropriate picture of the status of the property. The best way to avoid these workout environmental issues is to perform proper environmental due diligence at loan origination.