Small Business Administration's Modernized SOP Includes Environmental Policy Changes

In keeping with its goal of becoming easier for lenders to work with, the U.S. Small Business Administration recently modernized its standard operating procedure for lender and development company loan programs. While most of the modifications—including bullets, white space and appendices designed to improve readability—are structural, the SOP 50-10 (5) does contain some policy changes, including those that pertain to environmental due diligence. Lenders who make 7(a) and 504 loans should become familiar with the new, more rigorous environmental guidelines; they take effect June 15, 2008.

Environmental Due Diligence

To mitigate environmental risk, lenders and the SBA have long required pre-purchase environmental due diligence on commercial real estate to protect themselves from the risks associated with lending on contaminated property. The risks are fivefold:

- Contamination can adversely impact the value and marketability of the property used as collateral;
- It can have a negative impact on the borrower's creditworthiness and ability to repay the loan or operate the business;
- A lender or the SBA could be liable for environmental cleanup costs and third-party damage claims arising from contamination if the lender or the SBA takes title to the property as a result of foreclosure and/or exercises operational control at the property;
- Complications resulting from contamination can damage a lender's reputation, brand and image; and finally,
- If a governmental entity cleans a site, it may be able to file a lien for recovery of its costs which may be superior to the SBA's lien.

Due to time and cost constraints, a one-size-fits-all approach to environmental due diligence is not the norm in the lending community. Instead, most lenders let loan value and property specifics drive their due diligence approach. For example, larger loans and high-risk properties typically receive a Phase I environmental site assessment, while less expensive and faster transaction screen assessments or desktop due diligence reports are used to screen lower value loans and lower-risk properties.

With the release of its modernized SOP, which includes a similarly tiered approach to due diligence, the SBA's environmental policy is now more in line with current industry practices, making it easier for lenders to follow. Still, some requirements, such as the agency's mandate that only those who qualify as environmental professionals under EPA's All Appropriate Inquiry rule can conduct transaction screen assessments, and that all Phase I ESAs must be AAI-compliant, are more stringent than current industry standards and will necessitate a specialized approach.

Other notable changes to the agency's environmental policy include:

<u>A New Definitions Section:</u> While a future electronic version of the SBA's SOP will contain hyperlinks that will take the user directly to the definition of a specific term, the current version defines environmental terms in Appendix 2. One significant new term is *records search with risk assessment*—an environmental due diligence tool that includes a search of all databases required under EPA's All Appropriate Inquiry rule; historical use records for the property and any adjoining properties; and a risk assessment provided by either the records search company or, if the lender prefers, a qualified, independent environmental professional attesting that the property's environmental risk is either "high" or "low." (Lenders who make SBA loans will need to establish a "records search with risk assessment" level of due diligence if they haven't done so already.)

<u>Standardized Reliance Letter:</u> Appendix 3 of the SBA's updated environmental policy contains a new template to be completed by the environmental professional allowing borrowers, lenders and the SBA to rely upon the environmental report that has been prepared for the property in question. The standardized document contains a $1 million E&O insurance requirement, and only those consultants who meet the definition of "environmental professional" as set forth in EPA's All Appropriate Inquiry rule (40 CFR Section 312.10(b)) can sign off on it. The mandatory document also includes environmental contractor certification language. Lenders who aren't yet familiar with EPA's AAI rule should know that to qualify as an environmental professional, a person must:

1. Hold a current PE or PG license or registration from a state, tribe, or U.S. territory and have the equivalent of three years of full-time relevant experience;
2. Be licensed or certified by the federal government, a state, tribe or U.S. territory to perform environmental inquiries and have the equivalent of three years of full-time relevant experience;
3. Have a baccalaureate or higher degree from an accredited institution of higher education in a discipline of engineering or science and the equivalent of five years of full-time relevant experience; or
4. Have the equivalent of ten years of full-time relevant experience.

<u>NAICS Codes:</u> The North American Industry Classification System groups business establishments into industries based on their primary activity. Developed with the input of environmental professionals from around the country, Appendix 4 of the SBA's SOP contains a list of around 60 NAICS codes for environmentally sensitive industries, such as chemical manufacturers, textile mills, and photofinishing laboratories. NAICS codes, which have replaced the U.S. Standard Industrial

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Classification System (SIC codes), are an integral part of the SBA's environmental policy.

Changes in Environmental Investigation Steps: Under its new, tiered approach, the SBA does not require lenders to conduct a full-scale environmental investigation into every property. Rather, in keeping with current industry practices, the level of environmental due diligence the agency requires varies with the risks of contamination, which is determined by property specifics. Lenders who conduct an environmental inquiry under SBA's new requirements must first determine the NAICS codes for a property's current and past uses, then compare those codes to the list of environmentally sensitive industries in Appendix 4. If there's a match, the investigation must begin with an AAI- or ASTM E 1527-05-compliant Phase I environmental site assessment regardless of the amount of the loan. Otherwise, the agency allows the inquiry to begin with a lower level of environmental due diligence. For example, if no NAICS code matches are found, loans up to $50,000 can begin with an environmental questionnaire, which is sufficient provided the findings reveal that contamination is unlikely. (Under the SBA's new environmental policy, questionnaires are less likely to be the only tool used for environmental due diligence; this is most likely the reason why they are easier to complete, necessitating only a "good faith effort" on the part of the lender.) If the questionnaire does raise concerns, the lender must, at a minimum, hire a qualified environmental professional to conduct a transaction screen assessment. If the environmental professional identifies any further red flags during the course of the transaction screen assessment, the SBA requires that a Phase I ESA be conducted.

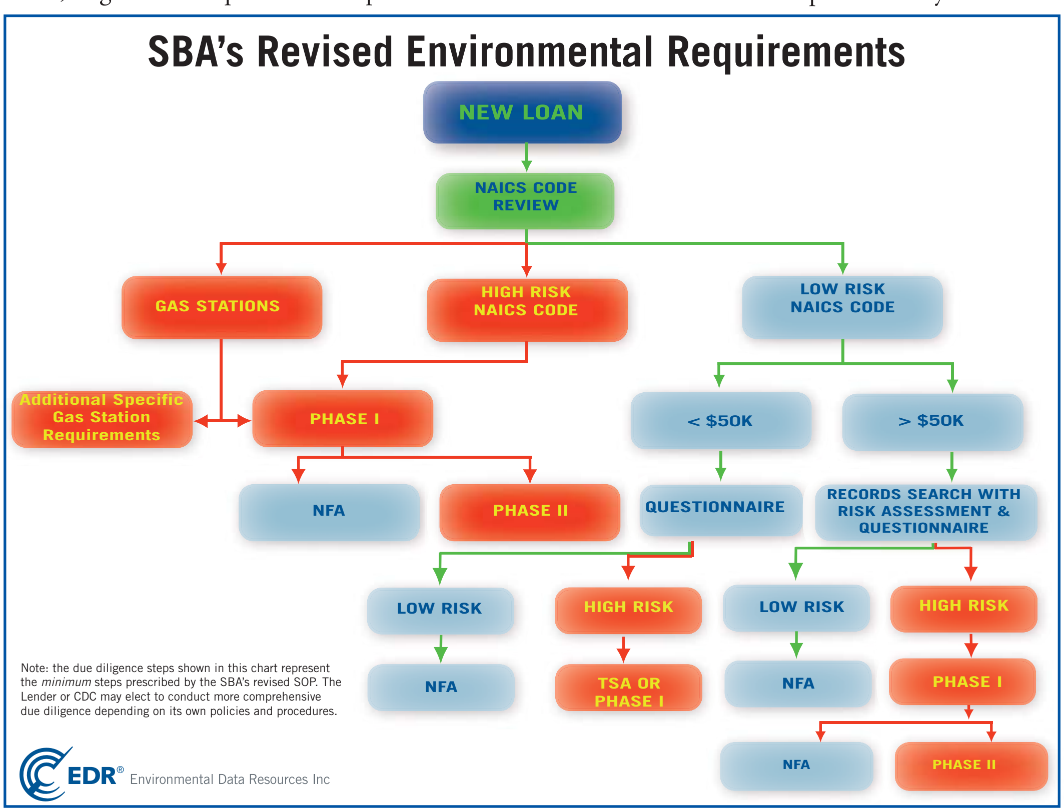
For loans greater than $50,000, investigations must, at a minimum, begin with a questionnaire paired with a records search with risk assessment. Properties identified by the records search with risk assessment as high risk require a Phase I ESA, while those identified as low risk are cleared as long as their questionnaire is clean.

If, after completing the Phase I inquiry, the environmental professional determines that further investigation is warranted and the lender still wants to make the loan, the SBA will likely require the lender to follow the environmental professional's recommendations, which typically include further testing. If a Phase II investigation identifies that contamination does in fact exist, the SBA may still approve the loan provided that steps have been taken to minimize risks.

New Gas Station Requirements: SBA loans for gas stations (NAICS codes that begin with 447), with or without convenience stores, necessitate a complex, specialized environmental due diligence approach that is addressed in Appendix 5. Requirements for a Phase I ESA, equipment testing, environmental insurance, an indemnification agreement and more are spelled out in the document.

New Indemnification Agreement: Appendix 6 contains a lengthy new indemnification agreement. The mandatory agreement eliminates the need for separate subordination agreements for gas station loans and replaces separate oil company agreements that the SBA used previously. A memorandum of the agreement is recorded in the real estate records for the protection of the lender and the SBA.

Additional Factors for Disbursement in the Presence of Contamination: Lenders who wish to obtain SBA loan approval for properties with contamination or ongoing remediation can often do so provided they can fit the borrower's circumstances into one of eight factors identified by the SBA as acceptable, such as by obtaining a "no further action" letter for the property in question. Under the SBA's new environmental policy, lenders who cannot fit their borrower's situation into one of these eight scenarios, but who still feel that disbursement is appropriate, have additional options. For example, the SBA may approve the loan if the borrower has adequate environmental insurance. Reliance solely upon these "other factors" requires consent from the agency's environmental committee.



Appeal Process: The SBA's updated environmental

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policy also has a new appeal process in the event of an adverse environmental determination. Lenders who believe that a decision rendered by an SBA field counsel or environmental engineer is inconsistent with the revised SOP may appeal to the agency.

Looking Forward

While a complete discussion of the SBA's environmental policy changes is outside the scope of this white paper, lenders can begin taking steps to meet the new requirements by reading the modernized SOP, paying particular attention to the SOP's appendices, where much of the critical information that pertains to the agency's environmental policy is found; making sure their environmental professionals are qualified to conduct AAI-compliant Phase I ESAs, and establishing a "records search with risk assessment" level of due diligence.

The SBA and various industry associations have hosted educational conferences to help lenders understand the complexities of the new policy. Lenders who missed one of the many training sessions or conferences can obtain training materials on the SBA's website. *To read a complete version of the SBA's new SOP, point your browser to http://www.edrnet.com/lenders.*