

# Know Your Environmental Due Diligence for SBA Loans

•• To take advantage of the federal stimulus program, lenders need to understand the environmental due diligence procedures required for SBA commercial real estate loans.

BY EILEEN M. HAZARD AND JOHN MUSSER

THE AMERICAN RECOVERY and Reinvestment Act of 2009 has increased interest in U.S. Small Business Administration (SBA) programs. The plans provide more than \$700 million in stimulus money to allow the SBA to reduce loan fees, expand parameters on popular loan programs, and offer incentives to businesses to save energy.

The SBA offers two loan programs that allow for the purchase of commercial real estate: 1) the SBA 7(a) program, which provides up to a \$1.5 million guarantee per loan for small businesses, and 2) the SBA Certified Development Company/504 program, a long-term financing program for businesses seeking to buy fixed assets. These loan programs require environmental investigations, which are outlined in the SBA's *SOP 50 10 5(B) for Lender and Development Company Loan Programs* (see Table 1).

The SOP is a dynamic document that can be changed by notice or actual revisions. The SBA plans to update the SOP semi-annually to keep policies and procedures current. A major rewrite of the SOP occurred in August 2008, minor revisions followed in March of this year, and SBA's most recent update takes effect October 1, 2009.

With the attractive guarantees and low fees available through the Recovery Act, lenders may want to offer SBA loan packages to borrowers looking to grow their small businesses. Understanding and keeping updated with the environmental due diligence procedures required by the SBA for 7(a) and 504 loans involving commercial real estate is an integral step for SBA lending.

Table 1  
Cross-reference Table for Environmental Information in SOP 50 10 5(B)

Topic	Appendix	Pages
Environmental policies for 7(a) loans	NA	189-196
Environmental policies for 504 loans	NA	289-296
Definitions of environmental terms	2	328-332
Questionnaire requirements	2	329-330
Template for reliance letter	3	333-334
NAICS codes for environmentally sensitive industries	4	335-336
Requirements for gas station loans	5	337-338
Template for SBA Environmental Indemnification Agreement	6	339-358
"Approval and Disbursement of Loans When There Is Contamination or Remediation at the Property"	NA	192-195 (7(a) loans) 292-295 (504 loans)

## The Steps of an Environmental Investigation

As part of the 504 or 7(a) programs, the SBA requires an environmental investigation of every commercial property that will serve as collateral for an SBA loan guarantee. The SBA employs a tiered approach to environmental investigations. The scope of the investigation depends on the potential risks for contamination associated with the property.

This article presents the *minimum* steps outlined in the SBA's October 2009 SOP for environmental investigations

(see flowchart on page 68). The procedures were put in place to minimize risks to the borrower, the lender, and the SBA.

**Getting started:** Determine the NAICS code.

To decide which type of environmental investigation is required for the property of interest, the lender must first make a good-faith effort to determine the North American Industry Classification System (NAICS) code for the property's current and known prior uses. An exception is made for purchasing a unit within a multi-unit building (for example, a shop within a strip mall). For these properties, the lender may proceed with the environmental investigation without determining the NAICS code for each unit. Appendix 4 of the SOP lists codes of industries considered environmentally sensitive.

If the NAICS code does not indicate that an environmentally sensitive industry is currently or was previously located on the property, the size of the loan will then determine the type of investigation required. At minimum, loans less than or equal to \$150,000 must begin with an environmental questionnaire. For loans over \$150,000, an environmental questionnaire along with a records search with risk assessment must be completed.

If the NAICS code reveals that a gas station or some other environmentally sensitive business is currently or was previously located on the property, the environmental investigation must begin with an All Appropriate Inquiries (AAI)-compliant Phase I Environmental Site Assessment (ESA), regardless of the amount of the loan. Lenders should be aware that the SOP calls for specific procedures for "special use" facilities (gas stations, dry cleaners, and day-care facilities), as discussed later in this article.

**Not an environmentally sensitive industry and loan is \$150,000 or less? Complete an environmental questionnaire.**

The environmental investigation begins with an environmental questionnaire for properties where the NAICS code is not for an environmentally sensitive industry. The SBA allows the lender to use the lender's own questionnaire, provided it includes the information listed in Appendix 2 of the SOP. Alternatively, the lender may access and download an example of a comprehensive environmental questionnaire at [www.envaluation.com](http://www.envaluation.com) (click on "News") or [www.seedcopa.com](http://www.seedcopa.com).

As part of the environmental investigation, the SBA requires the following:

- A site visit to the property by the lender completing or reviewing the environmental questionnaire.
- A good-faith effort by the lender to interview the current site owner or operator.
- Signature of the owner/operator on the questionnaire. (If the owner/operator will not sign the questionnaire it may not be used and lender must, at minimum, obtain a Transaction Screen.)

- Completion of the questionnaire up to one year prior to submission.

The SBA considers completion of a comprehensive environmental questionnaire to be a sufficient environmental investigation for loans valued below or equal to \$150,000, provided the results of the questionnaire show that contamination at the site is unlikely. A questionnaire indicating no potential for contamination must be submitted to the SBA for concurrence. If the questionnaire reveals potential for contamination for loans less than or equal to \$150,000, the SBA requires completion of a transaction screen for the property.

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**Loan valued over \$150,000 and property not connected to an environmentally sensitive industry? A records search with risk assessment must accompany the environmental questionnaire.**

When the loan value is over \$150,000, a records search with risk assessment must be completed along with the environmental questionnaire. Records search with risk assessment reports have been required for these SBA loans as of August 2008 when major revisions to the SOP took effect.

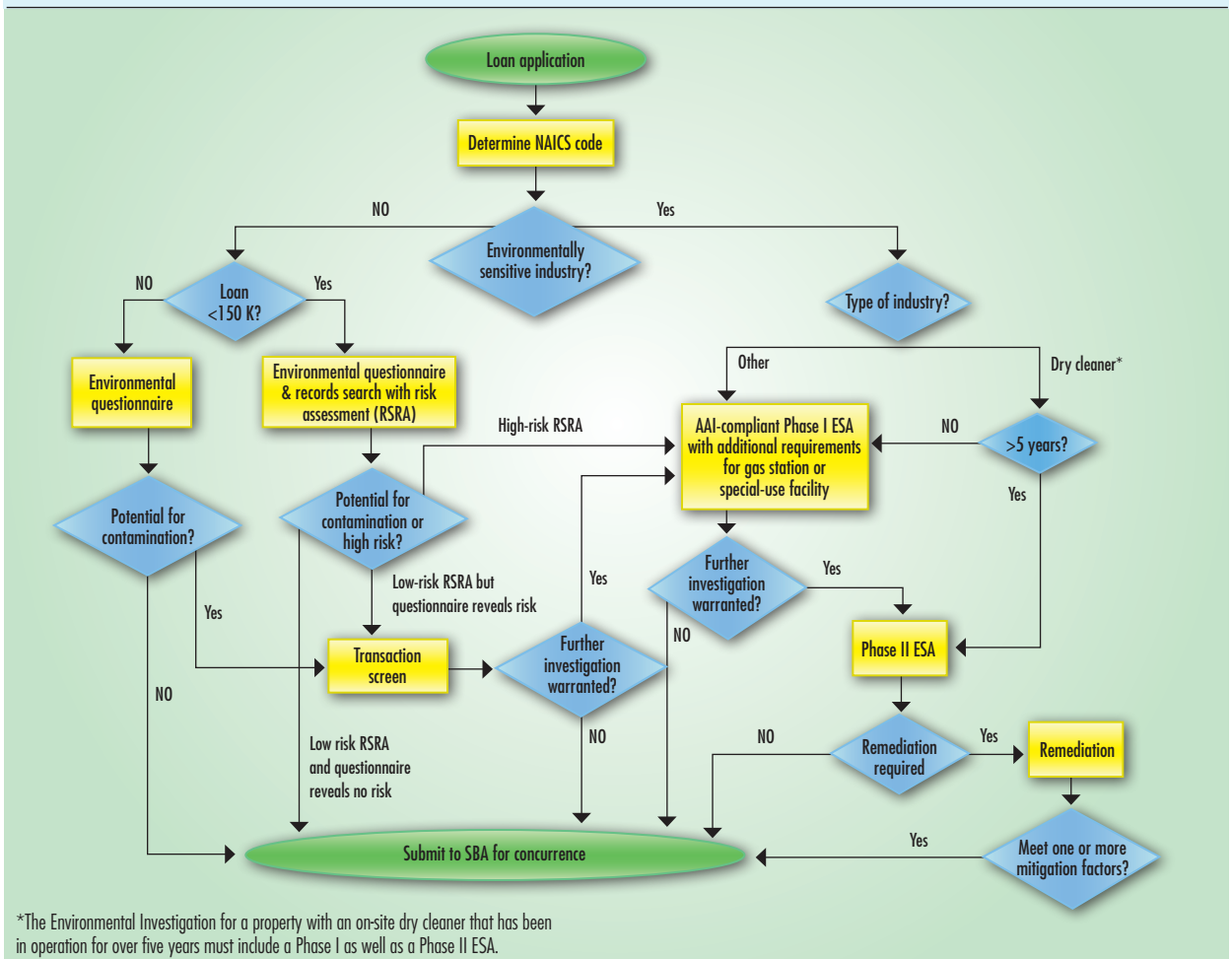
As of October 2009, a records search with risk assessment must include the following:

- A search of government environmental records (those databases identified for an AAI-compliant Phase I ESA).
- Historical documents (including fire insurance maps, reverse city directories, and aerial photographs).
- Summary of the findings written by a qualified environmental professional (EP).
- A site risk rating of high or low, assigned by the EP.

The EP conducting the risk assessment has discretion over which historical documents should be reviewed. The property location (for example, rural or urban) and the associated availability of documents will generally dictate which historical sources the EP deems relevant.

If the EP conducting the records search with risk assessment assigns a low risk rating to the property and the questionnaire indicates that environmental contamination is unlikely, the lender must submit the results of the environmental investigation to the SBA. When the EP assigns a high or elevated risk level, the SBA requires an AAI-compliant Phase I ESA of the property. A property with a risk rating of low that has a questionnaire result indicating potential for contamination should proceed, at minimum, with a transaction screen.

## The Minimum Steps for an Environmental Investigation for SBA 7(a) and 504 Loan Programs (Per October 2009 SOP 50 10 5B)



Questionnaire indicates potential for contamination? Conduct a transaction screen.

According to the SOP, the basic elements of a transaction screen include the following:

- An interview with the owner/operator of the property.
- A visit to the property with site reconnaissance conducted or supervised by an EP.
- Completion of an environmental questionnaire.
- A review of a government records search and historical sources.

The transaction screen must follow the most recently adopted standards for limited environmental due diligence as established by ASTM (currently, these are ASTM E1528-06).

The SBA requires that an EP conduct or supervise the environmental investigation and conclude either that the risk of site contamination is so minimal that no further investigation is warranted, or that the risk is sufficient to warrant additional investigation (a similar statement to this effect by

the EP is also acceptable). When the EP determines further investigation is warranted, the SBA requires completion of a Phase I ESA. The EP also should provide a detailed description of any additional recommended investigations.

As with the other types of environmental investigations, the lender must submit the results of the environmental investigation to the SBA with recommendations and seek the SBA's concurrence. Transaction screens completed up to one year prior to submission may be considered.

An environmentally sensitive industry or prior investigation indicates potential for contamination? Perform an AAI-compliant Phase I ESA.

When the property of interest has been identified with an environmentally sensitive industry (as per NAICS code) or the risk assessment with records search reveals a high or elevated risk rating, an AAI-compliant Phase I ESA must be completed. The Phase I must be completed by an EP

in accordance with ASTM E1527-05 (or the most recently adopted ASTM standard).

As with transaction screen requirements, the EP supervising the environmental investigation must conclude whether or not risk levels warrant additional investigation. For investigations revealing no risk of contamination, the results must be submitted to the SBA.

If having concluded that further investigation is warranted, the EP must describe recommended investigations in detail. A lender that still wants to make the loan must proceed with the recommendations of the EP—typically, a Phase II ESA. In most cases, the SBA will require compliance with the EP's recommendations, but there may be instances when an exception is warranted.

If the Phase I indicates potential environmental concerns with the property, the SBA will not approve the reports until the issues have been resolved. Lenders can avoid unnecessary delays in the environmental investigation process by addressing these concerns with their customer before forwarding the report to the SBA. This action will benefit the customer by reducing overall property transaction time and addressing a potential issue that could burden future sale of the property.

The following are two actual examples of the SBA environmental department rejecting the report because of outstanding environmental issues:

- A Phase I cited a 1,000-gallon underground storage tank (UST) used for storage of cooking oil and recommended that the UST be either sealed or removed. SBA acknowledged that the tank was not used for hazardous material, but rejected acceptance of the report until the UST was either sealed or removed.
- A Phase I report stated that several large heating oil USTs, including the surrounding soils, had been removed, but a closure certificate from the Pennsylvania Department of Environmental Protection (PA DEP) had not been obtained. The SBA would not approve the environmental report until proper certification from PA DEP was obtained. The loan application eventually was canceled.

EP concludes further investigation is warranted or a dry cleaner has operated on the site for more than five years? Conduct a Phase II ESA.

A Phase II ESA needs to be conducted when 1) the EP conducting the Phase I recommends a Phase II, or 2) the property has been the site of a dry cleaner in operation for more than five years. Lenders should note that a Phase I ESA must also be conducted for properties with dry cleaners. The Phase II ESA for SBA loans must be conducted by an EP in accordance with the most recently adopted ASTM standards (currently ASTM E1903-97) or generally accepted industry standards sufficient to identify contamination.

If a Phase II ESA reveals contamination at the property, the

lender first must decide whether or not to proceed with the loan. If the decision is to proceed with the loan, the lender is required to ensure that the EP has reported the following:

- Whether the contamination quantities exceed the reportable or actionable levels.
- Whether remediation is necessary.
- The estimated cost of recommended remediation.
- Projected completion date of remediation.

The lender will need to determine whether disbursement is appropriate under one of the SBA's factors identified in the section of the SOP titled "Approval and disbursement of loans when there is contamination or remediation at the property." The loan may be disbursed if, at any stage of the environmental investigation, the SBA concurs with the lender that risk has been minimized and no further investigation is required.

***If the Phase I indicates potential environmental concerns with the property, the SBA will not approve the reports until the issues have been resolved.***

Interested in disbursing a loan for a brownfield site or a property with known contamination or ongoing remediation? Determine if risks have been minimized and consider mitigating factors.

A lender may decide to proceed with a loan despite ongoing remediation or known contamination. SBA loan guarantees are available for the purchase of "brownfield" properties. As stated in the SOP, "SBA encourages the redevelopment of brownfields" (p. 196). For these properties, the SBA requires discussion of the following as part of the environmental investigation report:

- The nature and extent of the contamination.
- Method, status, and estimated cost of remediation.
- Collateral value.
- Mitigating factors.

The SBA lists several mitigating factors in the section of the SOP titled "Approval and disbursement of loans when there is contamination or remediation at the property":

- Indemnification.
- Completed remediation.
- No-further-action or closure letter issued by the government entity.
- Minimal remediation.
- Availability of sufficient cleanup funds or an escrow account.
- Groundwater contamination originating from another site that has not significantly affected the collateral or marketability of the property.
- Additional or substitute collateral.
- Factors listed under "other."

Each mitigating factor is defined in the SOP. The SBA will rely on one or more of them when deciding to disburse for brownfields and other properties with ongoing remediation, known contamination, or environmental monitoring. Lenders should refer to the full text of the SOP when proceeding with a loan on these properties.

Is the property a special-use facility such as a gas station, dry cleaner, or day care? Complete additional required environmental assessments.

Additional environmental risks will need to be evaluated when certain types of industries have operated on a property.

- **Day care and residential care facilities:** The SBA requires a lead risk assessment for properties constructed prior to 1980 that will be used for child care businesses (day-care centers or nursery schools) or residential care facilities. Per the SOP, risk of lead exposure from lead-based paint or lead in drinking water will need to be minimized prior to disbursement.
- **Dry-cleaning facilities:** A Phase I and Phase II ESA are required for properties with on-site dry cleaners that have been in operation for more than five years. With these facilities, the potential exists for costly remediation linked to the use of chlorinated solvents.
- **Gas stations:** Given the potential for significant remediation costs, the SBA has specific requirements for loans given for properties that currently or previously contained a gas station (see Appendix 5 of the SOP for more details):
  - The investigation must include an AAI-compliant Phase I ESA.
  - The EP conducting the work must hold a current professional engineer or professional geologist license and have the equivalent of three years of full-time relevant experience.
  - All USTs, lines, and related equipment must be tested by an independent contractor according to methods acceptable to the government entity with oversight authority.

As with other properties, if the investigation reveals no contamination, the lender must submit to the SBA for concurrence a report with investigation results and the EP's recommendations. For properties with contamination, refer to and follow procedures in "Approval and disbursement of loans when there is contamination or remediation at the property." Lenders proceeding with a loan to a gas station property with contamination must, at a minimum, obtain the SBA Indemnification Agreement and the seller must sign this agreement.

What costs are associated with environmental investigations? Costs will vary greatly, depending on the type of investigation and the property's characteristics.

The cost of an environmental investigation varies greatly,

depending on the loan value, the size and location of the property, and the scope of work involved.

- A records search with risk assessment report can be obtained for approximately \$400 to \$500, although the amount may increase slightly if the EP recommends review of additional data sources.
- Transaction screens generally run about \$1,000 per property.
- The cost for a Phase I ESA will vary, depending on the site characteristics (property size, number of buildings, location, geographic region), but lenders should expect to pay between \$1,800 and \$3,000 for a noncomplex Phase I ESA.
- A Phase I ESA for a gas station for an SBA-guaranteed loan requires the EP conducting the work to hold a current professional engineer or professional geologist license, and all USTs, lines, and related equipment must be tested. For a site with one midsized underground storage tank, a Phase I with these additional requirements would be expected to run at least \$5,000. The actual cost for each property will depend on the number, size, and age of the tanks and related equipment.
- A risk assessment for the presence of lead on a property will add to the cost of a Phase I ESA, and this cost will depend on 1) the number, age, and square footage of buildings on the property; 2) the buildings' piping; and 3) the square footage of painted walls.
- The price for a Phase II ESA will depend on the scope of work recommended by the EP, and each property will have a unique scope of work developed to accurately assess the potential for or extent of contamination. Tests such as soil and groundwater sampling, lead paint screening, and asbestos identification may be included. For example, collecting several surface soil samples for laboratory analysis of metals and petroleum compounds can cost several thousand dollars. Using a drilling rig to collect subsurface soil and groundwater samples at a site such as a gasoline station can cost from \$8,000 to \$15,000, depending on the number of samples required.
- The costs for remediation or ongoing monitoring projects are highly variable. While it is possible that some remedies (for example, simple tank removal and closure) may be implemented for several thousand dollars, some contaminated sites may require substantially more than this.

Submitting findings of an investigation, making an appeal, or have questions? Contact the SBA.

Results of the environmental investigation must be submitted to the SBA center processing the application for concurrence prior to approval of loan disbursement. Loans from the Preferred Lenders Program, SBA Express, the Pilot Loan Program, and the Premier Certified Lenders Program do

Table 2

### Reliance Letters

Required for transaction screens, Phase I, and Phase II ESAs.
Not required for records search with risk assessment (though EP is required to have \$1 million minimum per claim in errors and omissions insurance).
Requires signatures of EP and an authorized representative of employing firm.
EP and/or EP's firm must be covered by at least \$1 million in errors and omissions liability insurance.
New to SOP in March 2009: The template for the reliance letter was revised, and it is required even if the environmental investigation report is addressed to the lender.

not need to be submitted to the SBA, but lenders are still required to complete all steps of the environmental investigation procedures as per the SOP.

A reliance letter following the template in Appendix 3 of the SOP must accompany transaction screens and Phase I and Phase II ESA reports and is required even if the report is addressed to the lender (Table 2). Lenders should be aware that a reliance letter is not required for a records search with risk assessment, and these reports do not need to be addressed to the SBA.

SBA counsel will render an opinion on whether or not the environmental investigation is adequate and if the risk of contamination has been minimized. Lenders who feel the decision is inconsistent with the SOP may appeal by forwarding a copy of the decision and their explanation to [EnvironmentalAppeals@sba.gov](mailto:EnvironmentalAppeals@sba.gov). For general questions about the SBA's environmental policy, the SOP recommends contacting field counsel in the property's locality.

### Conclusion

The mission of the SBA is to start, build, and grow small businesses, and SBA loan programs are available to provide

financing opportunities to businesses that may not meet requirements for a conventional loan. Though the environmental requirements may seem daunting, lenders can streamline and simplify procedures by understanding the process and identifying professional firms with staff that understand SBA policy.

In the current economic environment and with special incentives offered as part of the American Recovery and Reinvestment Act, these loan programs are a great opportunity for lenders and small business owners to work together to promote the growth of small business success in the United States. ❖



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To help lenders keep current with policies and updates, the SBA's Web site, [www.sba.gov](http://www.sba.gov), offers a host of information. The full text of the most current SOP and a downloadable version of the "Steps of an Environmental Investigation" flowchart can be obtained at [www.envaluation.com](http://www.envaluation.com). Also available on that Website is a sample records search with risk assessment report. For 504 financing needs, details on the incentives offered as part of the recovery plan, or questions about SBA lending, visit SeedCo's Web site at [www.seedcopa.com](http://www.seedcopa.com).

#### Statement of Ownership, Management, and Circulation (Required by U.S. Postal Service Form (3526))

- Title of publication: The RMA Journal
- Publication no.: 763-620
- Date of filing: 8/17/09
- Frequency of issue: monthly, except January and August
- No. of issues published annually: 10
- Annual subscription price: \$110
- Location of publication: 1801 Market Street, Suite 300, Philadelphia, PA 19103-7398
- Location of headquarters of publisher: Same as #7
- Publisher: RMA—The Risk Management Association—Editor/Managing Editor: Kathleen M. Beans, Same as #7
- Owner: The Risk Management Association (RMA), Same as #7
- Known bondholders, mortgages, and other security holders owning or holding one percent or more of total amounts of bonds, mortgages, or other securities: None
- The purpose, function, and nonprofit status of this organization and the exempt status for federal income tax purposes: Has not changed during the preceding 12 months.
- Name of publication: Same as #1
- Issue Date for Circulation Data: September 2009
- Average No. Copies Each Issue During Preceding 12 Months.
  - Total no. Copies printed: 19,513
  - Sales through dealers and carriers, street vendors, and counter sales: None Mail subscription: 1,250 (Proof copies: 10)
  - Total paid circulation: 18,489
  - Free distribution outside the mail: 500

- Total free distribution: 500
- Total distribution: 8,989
- Copies not distributed: 525
- Total: 19,513
- Percent paid and/or requested circulation: 98%
  - Total no. Copies printed: 19,500
  - Sales through dealers and carriers, street vendors, and counter sales: 1,283
  - Total paid/requested circulation: 18,098
  - Free distribution outside mail: 500
  - Total free distribution: 500
  - Total distribution: 8,598
  - Copies not distributed. Office use, leftovers, unaccounted, spoiled after printing: 902
    - Return of news agents: None
    - Total: 19,500
  - Percent paid and/or requested circulation: 97%
- This statement of Ownership will be printed in the November 2009 issue of this publication. I certify that the statements made by me above are correct and complete.

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