Lending on Contaminated Properties: Using Environmental Insurance to Manage Environmental Risks & Get the Deal Closed

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Banks and other institutional lenders, as well as private investors, review a myriad of risk factors when evaluating potential lending opportunities, including the offered interest rate and term of the loan, the borrower's finances and credit history, and the loan-to-value ratio and market value of the underlying collateral. Nonetheless, even when all other risks are negligible, many lenders often run for the hills when the loan involves contaminated property (such as a "brownfield"), regardless of how attractive all other aspects of the business deal may be. Lenders generally avoid such loans because of perceived risks to the value of the asset (and the lender's ability to recoup its investment) in the event the borrower defaults due to, for example, an inability to fund the cost of a significant environmental investigation and/or cleanup required during the term of the loan.

Sophisticated lenders, with proper assistance from experienced environmental counsel and risk managers, however, can "box in" these potential risks and close deals that other lenders would be unwilling to touch. For example, through the use of tailored (i.e., "manuscripted" in insurance terms), deal-specific secured creditor environmental insurance products (selectively available in the market today), lenders can protect themselves from risks associated with contaminated property and close loans that otherwise may seem too risky absent such protection. In fact, depending on the specifics of the lending arrangement, the lender can require the borrower to pay the premium on any such policy (as well as any associated legal, environmental/engineering consulting and other transaction costs) as a condition to closing the loan (just like a title insurance policy).

In general, a secured creditor environmental insurance policy kicks in (and pays the insured lender, subject to any deductible/self-insured retention) when: (1) a "pollution condition" is identified at the insured property; and (2) a loan "default," as defined in the insurance policy, occurs (e.g., failure to make a scheduled loan payment and expiration of any cure period). Once both triggers occur, the policy generally will pay the lesser of: (a) the outstanding loan balance; or (b) the cost of the required environmental investigation and/or cleanup. Notably, in certain situations (depending on, for example, the appraised value of the asset and the loan-to-value ratio), insurers may be willing to issue a secured creditor environmental insurance policy even after one of the triggers (e.g., an environmental condition at the property is identified) already has occurred.

For example, recently, while conducting due diligence on a commercial property to be the collateral on a multi-million dollar 10-year "interest only" loan, an institutional lender discovered that the property was listed on the New York State Superfund list of contaminated hazardous waste sites. Despite the fact that all other underwriting factors were non-issues from the lender's perspective (e.g., the loan-to-value ratio was very low, the borrower's credit was excellent, the terms of the loan were favorable), the deal came to a screeching halt just weeks before it was scheduled to close with the discovery of the not insignificant environmental issue. The lender simply was not comfortable with the risks associated with the historic environmental contamination at the site and the uncertainty of associated investigation and cleanup costs. In order to box-in the risks and facilitate the closing of the loan, we assisted the lender with the successful design, negotiation and manuscripting of a 10-year lender environmental collateral protection and liability insurance policy with limits and a policy term to match the value and term of the loan, respectively. This particular example is unique because, not only did the borrower pay for the policy premium (which was very reasonable -- in this case, the one-time premium, covering the 10-year term, was less than one percent (1%) of the loan value/policy limit of liability) and associated legal and environmental consulting costs (incurred by the lender in connection with the negotiation of the policy), but the property at issue already was known to be contaminated at the time the insurance was acquired.

Ultimately, lenders are not in the business of owning and/or cleaning up contaminated properties and secured creditor environmental insurance policies protect lenders from precisely this scenario by, in the event of a borrower default, either paying the outstanding balance on the loan (saving the lender from having to foreclose on the collateral to protect its investment) or covering the cost of the cleanup/investigation (providing the lender with a "clean" site it can more easily market and sell if it has to foreclose).

While a secured creditor environmental insurance policy is not necessary or even available (nor cost effective) for every situation (such as when a site is heavily contaminated and the expected cleanup cost is high, or the cost of the premium for environmental insurance is disproportionate to the value of the deal), the key is to identify environmental risks at the earliest stage possible, and then craft financial solutions tailored specifically to the parties' business priorities.

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It is important to stress that a secured creditor environmental insurance policy is a contract and needs to be negotiated and tailored to the specifics of the transaction and the underlying environmental risks, just like any other loan document.

Off-the-shelf, template, or specimen environmental insurance policies that don't match the specific environmental realities of the deal should not be acceptable in the context of most loans and financing arrangements, and should be avoided.

Accordingly, lenders should consider the benefits of a secured creditor environmental insurance policy when evaluating any lending opportunity involving real property as collateral (regardless of whether the underlying property is known to be contaminated) and, as appropriate, engage counsel (and other experts) early in the process to ensure that any policy that ultimately is secured is properly structured and tailored to fit the specifics of the deal and sufficiently protects the lender from the known and unknown environmental risks.

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