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Dianne Crocker of Environmental Data Resources Inc. discusses the essential components of a bank's environmental risk-management policy and suggests practical guidance to ensure any updates are in line with its business model and goals.

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ELECTRONIC FUND TRANSFER ACT

Man sues Texas bank over allegedly unauthorized ATM user fees

A man has alleged in a class-action lawsuit filed in Texas federal court that a bank charged him a fee for using an ATM even though the institution was allegedly unauthorized to impose the expense.

Anderson v. Interstate Bank, No. 12-CV-16, complaint filed (N.D. Tex. Jan. 18, 2012).

Don Anderson says Perryton, Texas-based Interstate Bank illegally assessed a \$1.50 fee against him when he used one of the company's ATMs in Amarillo.

He says the bank is not allowed to charge ATM user fees because it did not comply with its disclosure obligations under the Electronic Fund Transfer Act, 15 U.S.C. § 1693.

The EFTA and its implementing regulations, found at 12 C.F.R. § 205, say ATM operators must

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Creating and updating an environmental risk-management policy

By Dianne P. Crocker, EDR Insight

Environmental contamination is a very real threat that can affect a bank's bottom line. By outlining due-diligence policies, practices and procedures for employees in a formal environmental policy, banks can help protect themselves from this unnecessary credit risk.

The following guidelines, developed over time by multiple banks through years of trial and error, can help banks develop an environmental policy if they do not have one or ensure that any updates are in line with the bank's risk-management goals.

WHY BANKS SHOULD HAVE AN ENVIRONMENTAL POLICY

Simply put, environmental risk is a credit risk and can have several possible consequences, including:

- Financial obligations for cleanup costs and fines that may result in loan defaults by borrowers.
- Remedial actions that may disrupt site access and impair occupants from doing business.
- Property-use limitations that can affect redevelopment plans.
- Pollution that can lead to bodily injury claims by occupants of the collateral or adjoining properties.
- Environmental issues that can damage a bank's reputation, brand and image.

A weak risk-management program could lead to losses that banks are ill-equipped to handle. Conversely, a sound environmental policy will help protect banks from credit risk and appease federal banking regulators, which have recently proposed guidance for banks and thrifts with high concentrations of commercial real estate mortgages.

Another reason for lenders to consider updating their environmental policies is that the Federal Deposit Insurance Corp. recently updated its Guidelines for an Environmental Risk Program to include the Environmental Protection Agency's "all appropriate inquiry" rule, after leaving it untouched for 13 years.

The update not only recommends that banks establish formal environmental due-diligence policies in every instance of extending credit, but urges them to consider adopting the AAI rule where appropriate. Other agencies, including the U.S. Small Business Administration, followed the FDIC's lead and have updated their environmental policies as well.

WHAT TO INCLUDE

The goal of environmental due diligence is to understand the environmental risk associated with a transaction and then factor it into the overall credit analysis. The bank's business units can provide an understanding of the types of lending the bank does, the markets it serves, its business objectives and its risk appetite. (Some lenders tend to be risk-averse while others are willing to accept some risk in order to build market share or delve into new markets.) The distinction should be accounted for in the environmental policy.

Lenders can decide what their risk tolerance is by asking management how much money is considered material in the event of a loss or write-off and whether management is willing to take collateral that is contaminated. Once lenders understand the bank's business model and risk appetite, they can answer the following questions to help shape the environmental policy:

- **What type of property is typically used as collateral?** Commercial and industrial sites have a higher likelihood of contamination than residential properties, but all real estate, regardless of use, can be affected by environmental issues. As a rule, industrial sites require more scrutiny than residential homes.
- **Where are lending activities concentrated?** The characteristics of a region can influence environmental risk. Lenders should consider the region's regulatory climate, geologic sensitivity, groundwater use and development trends. National and international

banks can tailor policies to account for regional differences.

- **How old are the properties the bank typically lends on?** The longer a property has been in use, the greater the chance that on-site activities have led to contamination. Lenders should keep in mind, though, that pollution can migrate and contaminate virgin land.
- **How big is the bank?** While the risks stemming from contamination are comparable for both small and large banks, small banks have more exposure. Conversely, because large banks have less exposure and can afford to keep experts on staff who can interpret environmental data, they can get away with less conservative thresholds for environmental due diligence.

POLICY SPECIFICS

The following components are vital to a successful environmental policy and should be tailored to the bank's objectives and risk appetite, once defined:

- **Objective:** Lenders should define why they have developed an environmental policy and include the business units or groups that are required to adhere to the policy.
- **Roles and responsibilities.** Lenders should clarify who must use the policy, who will enforce it, who can approve changes and who, if anyone, has the right to waive it — and under what circumstances. In some banks, the task of enforcement falls to the commercial credit administration department. In others, the responsibility falls on the environmental department (if the bank has one), the approval department or senior management, such as a credit risk officer. Lenders should also define whose responsibility it is to review environmental due-diligence reports. This may vary depending on whether the report recommends further action and is prepared for a borrower, is prepared

for a third party, or if a state or federal agency is involved.

- **Personnel training.** Lenders must define the terms and issues relating to the value of real estate and/or the creditworthiness of the borrower. Banks should consider training the loan-documentation department on the policy's features, so they can evaluate whether closed loans were subject to the proper environmental due diligence.
- **Types of properties subject to the policy.** Underwriters must be given clear guidelines on when properties are subject to environmental due diligence. All commercial real estate, including bank-owned real estate, commercial real estate lending, acquisition and development lending, commercial real estate whole-loan purchase, and commercial and industrial lending should be addressed in the policy. Lenders should also consider including residential property suspected to have risks such as mold or vapor intrusion.
- **Risk analysis.** Lenders must identify which specific transactions require scrutiny.
- **Tiered approach.** Lenders should define which environmental due-diligence tool should be used for a given scenario. Considerations include funding source, property type, property location, loan amount, etc.
- **Ongoing monitoring.** Lenders should define how often they wish to obtain updated information about environmental risks, indemnities, conduct in nonperforming or other troubled loans, and what bank employees should or shouldn't do to ensure secured-creditor protection.
- **Vendor/environmental professional policy.** The vendor-approval process should be spelled out and should include mandatory qualifications for outside environmental consultants. Banks should set up an account with a database vendor that can provide environmental-records search reports.
- **Other considerations.** Lenders should spell out what levels of environmental due diligence and review are required for renewals, restructures and other subsequent transactions. Critical

considerations include amount of new money, age of prior due-diligence reports and any material change in collateral condition or use. Lenders should also determine what levels of environmental due diligence and file review are required at the pre-foreclosure stage, and clarify responsibility for review prior to taking title.

- **Updating.** Lenders should decide on a policy-updating schedule. Most banks review the policy annually to ensure that it remains in line with the business model and goals, or sooner if regulatory or other issues warrant it.

SETTING THRESHOLDS

Developing a tiered environmental due-diligence approach is arguably the most complex portion of writing the environmental policy. Because it is not practical to require exhaustive environmental due diligence for every transaction, most lenders use an approach that progresses from a quick, inexpensive database report to a more

thorough tool such as a transaction screen assessment, culminating with a full-scale, phase I environmental site assessment that complies with the Environmental Protection Agency's "all appropriate inquiry" rule or its equivalent, ASTM's E1527-05 standard.

In cases where contamination is known or suspected, due diligence may even go beyond a phase I ESA and include additional investigation or sampling to characterize the extent of the problem (a phase II). Each of these six commonly used environmental risk-management tools has a place in a sound risk-management program:

1. Phase I environmental site assessment
2. Transaction screen assessment
3. Desktop review/collateral screen
4. Environmental questionnaire
5. Site visit
6. Environmental indemnification agreement

Lenders should note that the Small Business Administration added a new level

of environmental due diligence — records search with risk assessment — to its most recent policy update, SOP 50-10(5). The tool includes a search of all databases required under AAI, historical use records for the property and any adjoining properties, and a risk assessment (high or low) provided by an environmental professional. Lenders should create a chart of these tools to make it easier for their underwriters to make environmental due-diligence decisions.

The chart should include variables such as the size of the transaction, its perceived risk, the historical environmental problems on the subject or adjacent properties, whether the transaction will later be sold in the secondary market, the bank's risk tolerance, the level of environmental expertise available at the bank, whether the loan is guaranteed by the SBA, and other criteria pertinent to the bank's business model, such as the borrower's relationship with the bank.

Lenders must keep in mind that environmental risk is a function of a site's current and past use and may not be reflected in its current value. As such, the

A sound environmental policy will help protect banks from credit risk and appease federal banking regulators.

degree of due diligence should not be based on loan value alone.

If liability protection under the Comprehensive Environmental Response, Compensation and Liability Act for the borrower is important to the bank, only an AAI- or E1527-compliant phase I ESA will suffice. Put another way, if a property purchaser wishes to take advantage of any of the three liability defenses to CERCLA (the innocent landowner, bona fide prospective purchaser or contiguous property owner defense), he or she has no choice but to have an AAI- or E1527-05-compliant phase I ESA prepared by an environmental professional for the property in question.

Although an AAI-compliant phase I ESA is arguably the new standard of care in environmental risk management, and many lenders require one for every transaction where a phase I ESA is standard practice, it's not always practical to require one. Fortunately, database reports are effective screens, and can provide a low-cost, quick alternative when time is short and budget is tight. They can be used when CERCLA liability

protection isn't a concern and the user has no reason to suspect that an environmental problem will arise. If suspicions are raised or problems are discovered, the lender can always increase the level of due diligence.

APPROVING ENVIRONMENTAL PROFESSIONALS

Developing an approved list of environmental professionals presents another challenge. Lenders must decide what qualifications to accept (only those meeting the definition of "environmental professional" under the EPA's AAI rule can conduct AAI- or ASTM E 1527-05-compliant phase I ESA.) Lenders also must decide who will approve individual vendors and who will review and maintain the list.

They should also spell out whether they will accept reports from non-approved consultants and under what circumstances and whether to accept existing reports and under what criteria (seller-prepared reports vs. bank- or client-prepared, reports on suspect properties, outdated reports, incomplete reports, etc.).

ADDITIONAL CONSIDERATIONS

Lenders can fine-tune the environmental policy by addressing issues such as whether to differentiate between high-risk properties like manufacturers and low-risk properties

like apartments, whether they will lend on contaminated properties or gas stations, how they will handle waivers, and what pre-foreclosure due diligence to require.

Banks should also address "continuing obligations." In its most recent environmental policy revision, the FDIC recommends that the lender's environmental risk assessment extend over the life of the loan. This ties in with the EPA's AAI rule requirement that property owners comply with continuing obligations over the course of property ownership, which preserves their ability to raise a liability defense under CERCLA.

All real estate, regardless of use, can be affected by environmental issues.

Many banks' environmental policies do not address this issue directly; nonetheless, they monitor properties by conducting regular site inspections and collateral assessments over the life of the loan. Lenders should consider whether this is sufficient for their bank.

Lenders should also run the final draft of their environmental policy by an environmental attorney or environmental professional, who can help ensure that due-diligence guidelines are in line with the

bank's overall risk-management goals. Bank personnel should read and understand the environmental policy, and make sure senior management, including the senior credit-risk officer, will enforce it. **WJ**



Dianne P. Crocker is a principal analyst for **EDR Insight**, the analytical research team of Environmental Data Resources Inc. With 20 years of experience in the environmental industry, Crocker provides strategic data and analysis on environmental due-diligence trends to environmental consultants, commercial real estate lenders, corporations and other parties involved in real estate transactions.