Environmental Risks of Acquiring Property by Foreclosure

by James Brennan and Thomas A. Utzinger

James Brennan is Corporate Counsel of 1031 Exchange Solutions Group. Thomas A. Utzinger is an environmental attorney practicing in New Jersey, New York, and Washington, D.C., with experience in regulatory compliance and environmental issues in transactions.

Lenders, bondholders, and other holders of interests in commercial and industrial real estate, beware the decision to foreclose on properties contaminated by hazardous substances. The "long claws" of environmental laws can threaten real estate lenders and securitized bondholders alike. The laws and policies governing the meaning of what constitutes "ownership" or "operation" for the purpose of environmental liability must be carefully understood, as foreclosure may alleviate troubled loan portfolios but, in turn, may lead to a broader set of troubles. This topic is ripe for review during this current economic climate, as the need to address above-average numbers of foreclosures in a timely manner can compromise full compliance with environmental laws.

As if the myriad challenges in real estate today, with credit market troubles, tightened lending standards, and a maturity cliff veering troublingly close, were not enough, the lending and financial community must also be aware of certain environmental laws that can sweep in a broad cast of parties lacking the intention or desire to be responsible for significant cleanup costs. This cast of "responsible parties" includes not only past and present property owners, but also lenders and even securitized bondholders.

I. Federal Law Governing Environmental Liability for Foreclosures

While the list of environmental laws regulating property owners is abundant, only a few laws are broad enough in reach to impact nonowners, especially lenders who, as a matter of course, regularly threaten to "take back the keys" to properties. The most prominent environmental law wielding this power is the federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA),[1] also known as the Superfund law, intended to impose liability on responsible parties for properties contaminated by hazardous substances and to require site cleanup or the payment of cleanup costs.[2] Other relevant laws include state laws analogous to CERCLA and/or addressing lender liability. This type of forced-hand liability makes most real estate lenders exercise due caution, as certain actions before or after foreclosures can unknowingly trigger liability for the cleanup of contaminated properties.

CERCLA, as originally enacted, and to the most extent as it functions today, notoriously leads to examinations of chain of title and holds multiple parties jointly and severally liable for site cleanups. In particular, CERCLA §107(a) identifies four broad categories of potentially responsible parties (PRPs) that are strictly liable (regardless of actual fault) for cleanup costs when the federal government, state government, or a private party brings suit.[3] The first two categories include present, and past, "owners and operators" of properties contaminated by hazardous substances.[4] The third category includes persons who arranged for the disposal of hazardous substances.[5] The final category includes persons who transported the hazardous substances and selected disposal sites.[6] The issue of lender liability applies to the first two categories of PRPs, present owners and operators and past owners and operators.

As originally passed in 1980, CERCLA set forth an important "security interest exemption" from "owner or operator" PRP status for those persons or entities who, without "participating in the management of" a property, hold indicia of ownership in the property primarily to protect a security interest.[7] Not long afterward, the financial and lending community expressed uncertainty as to the exact meaning of this exemption, especially what constituted "participating in the management" of properties. To misinterpret it and engage in

1. 42 U.S.C. §§9601-9675, ELR Stat. CERCLA §§101-405.
2. The reader should note that while the universe of CERCLA "hazardous substances" is quite broad, it does not include petroleum, crude oil or fractions thereof, natural gas, natural gas liquids, liquefied natural gas, or synthetic natural gas usable for fuel. 42 U.S.C. §9601(14). For a complete list of CERCLA hazardous substances, see 40 C.F.R. §302.4, tbl. 302.4. Due to this important exception, the U.S. Environmental Protection Agency (EPA) has issued lender liability rules for properties containing certain types of petroleum underground storage tanks (USTs). These rules may be found at 40 C.F.R. §§280.200 et seq. *See also* U.S. EPA, Underground Storage Tanks—Lender Liability; Final Rule, 60 Fed. Reg. 46691 (Sept. 7, 1995).
3. 42 U.S.C. §9607(a).
4. 42 U.S.C. §9607(a)(1)-(2).
5. 42 U.S.C. §9607(a)(3).
6. 42 U.S.C. §9607(a)(4).
7. 42 U.S.C. §9601(20)(A) (1980).

actions that fall outside the exemption could label a lender as an "owner or operator" responsible for environmental cleanup costs. Unfortunately, there was little historical guidance as to what the U.S. Congress specifically meant by the exemption in terms of specific actions, and courts disagreed as to what degree of "participation in the management" of properties was permissible, and even whether the exemption applied after foreclosure.[8] Without useful legislative history or consistent legal precedent pertaining to the security interest exemption, lenders were left to interpret CERCLA's language and act, sometimes to their detriment.

Given this original uncertainty, the U.S. Environmental Protection Agency (EPA) issued the Lender Liability Rule of 1992, which was meant to clarify the range of activities that may be undertaken by persons holding indicia of ownership in properties, without being considered "participating in the management" of properties.[9] The 1992 rule applied to, but was not limited to, indicia of security interests, such as mortgages, deeds of trust, legal or equitable title obtained pursuant to foreclosure or its equivalents, surety bonds, guarantees of obligations, assignments, liens, pledges, and title held pursuant to lease financing transactions in which lessors do not initially select leased properties.[10] The rule also noted that covered security interests could arise from sale-leasebacks, conditional sales, installment sales, trust receipt transactions, certain assignments, factoring agreements or accounts receiving financing agreements, and consignments, so long as the transaction established some interest in real property.[11]

Although the 1992 Lender Liability Rule was vacated by a federal appeals court in 1994 because EPA failed to establish its authority to specifically limit CERCLA statutory liability through regulation,[12] EPA and the U.S. Department of Justice, in response, asserted in a 1995 official policy statement that the agencies would continue to honor the interpretations set forth in the vacated 1992 Lender Liability Rule, when the agencies were considering enforcement actions under CERCLA.[13] This was good news for the lending and financial world.

Despite this agency policy statement, Congress took more formal action in 1996 to settle remaining uncertainty stemming from the prior four years of EPA interpretations. The Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 (Asset Conservation Act) amended CERCLA to essentially codify the 1992 Lender Liability Rule and set forth a safe harbor that addresses with more specificity what constitutes "participation in management" and whether foreclosures make lenders liable under CERCLA as "owners" or "operators" of contaminated properties.[14] EPA subsequently issued memoranda on the Asset Conservation Act in 1996 and 1997.[15] Since then, it has become common for companies in the lending and financial industries to mention the federal exemption in Securities and Exchange Commission filings.[16]

Disregarding the parameters of the security interest exemption can indeed lead to liability. In *New York v. HSBC USA, N.A.*,[17] for example, the lender, HSBC Bank, did not qualify for the exemption because its financial management policies prevented the borrower, Westwood Chemical Co., from having the financial means to properly dispose of hazardous substances. The lender's lockbox cash management system led to denials of requests by the borrower for necessary funds to comply with environmental laws, resulting in contamination of the borrower's property.[18] In a settlement, HSBC paid the state of New York $850,000 in civil penalties, $68,000 in reimbursement costs, and $48,000 in enforcement costs.[19] The overall costs were substantial, as EPA also spent approximately $3 million in cleanup.[20] Had HSBC granted West-

8. *See, e.g.*, United States v. Fleet Factors Corp., 901 F.2d 1550, 20 ELR 20832 (11th Cir. 1990), *cert. denied,* 498 U.S. 1046 (1991) (participating in financial management to a degree indicating a capacity to influence control over environmental matters was sufficient to impose CERCLA liability, whether or not control actually was exercised); Bergsoe Metal Corp. v. East Asiatic Co. (In re Bergsoe Metal Corp.), 910 F.2d 668 (9th Cir. 1990) (mere capacity to control a facility is insufficient, and there must be some actual management involved before a secured creditor will fall outside the security interest exemption); Guidice v. BFG Electroplating & Manufacturing Co., 732 F. Supp. 556, 20 ELR 20439 (W.D. Pa. 1989) (the security interest exemption is lost following foreclosure); and United States v. Mirabile, No. 84-2280, 1985 WL 97, 15 ELR 20994 (E.D. Pa. Sept. 4, 1985) (the security interest exemption applies after foreclosure for a bank that purchases a site at foreclosure and sells or assigns the interest within a few months after purchase).
9. U.S. EPA, National Oil and Hazardous Substances Pollution Contingency Plan; Lender Liability Under CERCLA, 57 Fed. Reg. 18344 (Apr. 29, 1992).
10. 57 Fed. Reg. at 18374.
11. *Id*. at 18375.
12. Kelley v. EPA, 15 F.3d 1100, 24 ELR 20511 (D.C. Cir. 1994), *reh'g denied*, 25 F.3d 1088, 24 ELR 21204 (D.C. Cir. 1994), *cert. denied*, American Bankers Ass'n v. Kelley, 115 S. Ct. 900 (1995).
13. U.S. EPA Office of Site Remediation Enforcement, CERCLA Enforcement Against Lenders and Government Entities That Acquire Property Involuntarily, 60 Fed. Reg. 63517 (Dec. 11, 1995).
14. Asset Conservation, Lender Liability, and Deposit Insurance Protection Act, Pub. L. No. 104-208, 110 Stat. 3009-462 (1996).
15. U.S. EPA Office of Site Remediation Enforcement, *Recently Enacted Lender and Fiduciary Liability Amendments* (Oct. 3, 1996), *available at* http://www.epa.gov/compliance/resources/policies/cleanup/superfund/lend-fiduc-amend.pdf; U.S. EPA Office of Site Remediation Enforcement, *Policy on Interpreting CERCLA Provisions Addressing Lenders and Involuntary Acquisitions by Government Entities* (June 30, 1997), *available at* http://www.epa.gov/compliance/resources/policies/cleanup/superfund/lendr-aquis-mem.pdf.
16. See, for example, the SEC 424B3 filing of Commerce Street Pantheon Mortgage Asset Securitizations LLC, noting that

    > [u]nder the laws of some states and under [CERCLA], current ownership or operation of a property provides a sufficient basis for imposing liability for the costs of addressing prior or current releases or threatened releases of hazardous substances . . . [and] a secured lender who holds indicia of ownership primarily to protect its interest in a property may, by virtue of holding such indicia, fall within the literal terms of the definition of "owner" or "operator;" consequently, such laws often specifically exclude such a secured lender from the definitions of "owner" or "operator," provided that the lender does not participate in the management of the facility. . . . [But] a lender will lose the protection of the secured creditor exclusion only if it exercises decision-making control over the borrower's environmental compliance and hazardous substance handling and disposal practices or assumes day-to-day management of all operational functions of the secured property.

    424B3 at 58-59 (Oct. 6, 2009), *available at* http://www.sec.gov/Archives/edgar/data/1457989/000095012309048537/v47415be424b3.htm.
17. No. 07-3160 (S.D.N.Y. May 30, 2007).
18. Matthew H. Ahrens & David S. Langer, *Lender Liability Under CERCLA—Environmental Risks for Lenders Under Superfund: A Refresher for the Economic Downturn*, Bloomberg Finance (2008).
19. Karen Freifeld, *HSBC Bank Will Pay New York $966,000 to Settle Case (Update2)*, Bloomberg (May 30, 2007), *available at* http://www.bloomberg.com/apps/news?pid=20601109&sid=a87yhnWc.q1U&refer=exclusive.
20. *Id*.

wood the funds necessary to comply with environmental laws and avoid contamination, HSBC would not have later been subject to liability for the Westwood contamination.

In contrast, following the rules of the exemption will lead to avoidance of liability should a lender face a lawsuit by the government. The lender in *United States v. Pesses* satisfied the exemption by, after foreclosure, promptly listing the subject property with real estate agents and seriously considering inquiries from potential buyers. More importantly, when the lender realized that it could not sell the property due to the existing environmental conditions, it turned the keys of the property over to a bankruptcy trustee instead of indefinitely holding onto the property and acting like a long-term owner.[21]

II. State Laws Also May Be Relevant to Foreclosures on Contaminated Properties

Some states also have environmental laws that address lender liability for contamination, and, while similar to CERCLA, these laws can differ from the federal law to some degree. The most important distinction between CERCLA and analogous state laws is that federal and state laws are not mutually exclusive, and in the case of a contaminated property, liability can follow from CERCLA, the state law, or both.

One direct example is New Jersey's Spill Compensation and Control Act (Spill Act), which protects lenders who hold indicia of ownership of contaminated real property, exempting them from being persons "in any way responsible" for discharges of hazardous substances, so long as they do not participate in the property's management.[22] With respect to post-foreclosure activities, the Spill Act requires security interest holders, within five years of foreclosure, to sell, relet, or divest the contaminated property in "a reasonably expeditious" manner as evidenced by the use of "commercially reasonable means."[23] The Spill Act's liability regime also goes beyond that of CERCLA, as the New Jersey law explicitly imposes liability on holders if discharges of hazardous substances occur at the foreclosed property after foreclosure and are due to the lender's negligence.[24] However, if a property has both preexisting and new discharges at the time of foreclosure, a lender may perform an environmental audit and submit it to the state to determine for which discharges the lender must assume responsibility.[25]

Another example is New York's security interest exemption, established as part of the 2003 Brownfield Cleanup Act Amendments to Article 27 of the state's Environmental Conservation Law.[26] The law states that lenders will avoid liability as owners or operators of hazardous waste sites provided that lenders, without participating in the management of sites, hold indicia of ownership primarily to protect security interests. Lenders of such properties in New York must, after foreclosure, take actions to sell, relet, or otherwise divest "within a commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."[27]

It therefore is crucial for lenders to know the state-specific laws governing foreclosed contaminated properties, as some of these state laws, like New Jersey's Spill Act, can impose requirements in addition to those required by the federal CERCLA law. The environmental laws of the state in which the property is located should be carefully reviewed before engaging in a foreclosure.

III. Ways to Avoid CERCLA Environmental Liabilities Relating to Foreclosures

Lenders therefore are left with a checklist of items related to assets facing foreclosure.[28] With respect to financial and environmental management, a lender MAY:

- Perform or fail to perform an act prior to creation of the security interest;
- Hold, abandon, and release a security interest;
- Restructure or renegotiate the terms of a credit or security agreement, or exercise forbearance;
- Monitor and legally enforce the terms of a credit or security agreement;
- Provide financial advice to a borrower in order to avoid default or diminution of the value of the property;
- Conduct periodic reviews of a debtor's finances;
- Maintain business activities and conduct wind-up operations after foreclosure;
- Conduct due diligence before making a loan, such as retaining an environmental consultant to perform, at a minimum, a Phase I environmental site assessment in compliance with EPA regulations at 40 C.F.R. Part 312, and in some cases, also conducting an audit of the business' or property's compliance with environmental laws[29];
- Monitor or inspect a property and on-site operations;
- Include and enforce an environmental covenant or warranty in a credit or security agreement;

21. United States v. Pesses, 1998 WL 937235 (W.D. Pa. May 6, 1998).
22. New Jersey Spill Compensation and Control Act, N.J. Stat. Ann. 58:10-23.11g4-g7.
23. N.J. Stat. Ann. 58:10-23.11g6.
24. N.J. Stat. Ann. 58:10-23.11g6(e).
25. *Id*.
26. N.Y. Envtl. Conserv. Law §27-1323, A. 9120 Part E, Sec. 9, 2003 N.Y. Laws 1041 et seq. (Oct. 7, 2003).
27. N.Y. Envtl. Conserv. Law §27-1323(1)(a)(2).
28. *See also* U.S. EPA Office of Site Remediation Enforcement, *CERCLA Lender Liability Exemption: Updated Questions and Answers* (July 2007), *available at* http://www.epa.gov/compliance/resources/publications/cleanup/superfund/factsheet/lender-liab-07-fs.pdf.
29. When conducting environmental due diligence, it is imperative to also confirm whether or not state-level requirements apply to the investigation in addition to the CERCLA Phase I. New Jersey, for example, requires that a "Preliminary Assessment" be conducted in order to demonstrate proper due diligence, and the Preliminary Assessment procedures do differ from those of the Phase I. N.J. Stat. Ann. 58:10-23.11g(d)(2)(d).

- Require that other parties address on-site contamination, such as encouraging (but not requiring or dictating) that the borrower resolve environmental problems during the life of the loan; and
- Conduct cleanup activities under the direction of an on-scene coordinator.

And, with respect to financial and environmental management, a lender SHOULD NOT:

- Exercise control over the property at the level of a manager responsible for day-to-day operational, financial, and administrative matters;
- Invest capital in the property;
- Expand the business being conducted on the property;
- Be deemed a person in control of the borrower during a loan workout period; and
- Exercise decisionmaking control over the handling and disposal practices of hazardous substances at the property.

Equally important to the lists above, lenders who do foreclose must also use best efforts, subject to market conditions, to sell the asset by listing the property with a broker or advertising it for sale in an appropriate publication within 12 months after foreclosure.[30] It also is a good practice to act upon bona fide offers for fair consideration within 90 days of receipt any time within six months following the foreclosure. Lenders who hold onto foreclosed properties for too long a period without making good-faith efforts to divest the properties will appear to be owners of the properties and be at risk for enforcement by government agencies. This is exactly the status lenders want to avoid.

IV. Conclusion

These considerations are dramatically heightened for lenders that focus on industrial properties. In the cases of defaults or potential defaults, borrowers in this context end up having more leverage over lenders, because the lenders do not want to foreclose due to the liabilities. In order to move forward with foreclosure, a lender must conform to the current federal and state environmental laws governing the subject property, in order to avoid liability. Nevertheless, it is likely that up through 2011, the lending industry may see a pullback in refinances in industrial areas, more renegotiations than foreclosures with properties that have contingent environmental liabilities, and, finally, banks instituting compliance procedures for servicing defaults.

30. *See* Question 5, U.S. EPA Office of Enforcement Compliance Assurance, *Superfund Frequently Asked Questions: Laws, Policy, and Guidance*, *available at* http://www.epa.gov/compliance/resources/faqs/cleanup/superfund/laws-faqs.html.