Environmental Risks to Foreclosing Lenders

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Lenders should consider environmental liability risks and protections under the federal Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA") before taking a security interest in or foreclosing on real property. CERCLA provides for strict, joint and several liability for parties potentially responsible for a release of hazardous substances. Potentially Responsible Parties ("PRPs") include: current owners and operators; past owners and operators at the time of disposal of any hazardous substances; any person who arranged for the disposal, treatment or transport of a hazardous substance; and transporters of hazardous substances. PRPs are liable for all costs of remediation, response actions, natural resource damages and certain other costs incurred as a result of the release of hazardous substances. CERCLA, however, provides liability protections for lenders before and after foreclosing on real property, provided certain criteria are met. Real estate lenders should carefully evaluate steps that may be necessary to satisfy these criteria before taking a security interest in or foreclosing on their collateral.

LENDER LIABILITY PRIOR TO FORECLOSURE

CERCLA exempts *qualified* lenders from the statutory definition of "owner or operator." In order to qualify for this liability exemption prior to foreclosure, a lender must not "participate in the management" of a facility and must hold "indicia of ownership" primarily to protect its security interest in the facility or real property.

Each case is fact-specific, but the term "participate in management" means actually participating in the management or operational affairs of a facility. It does not include merely having the capacity to influence, or the unexercised right to control the facility. A lender participates in management if, while the borrower is still in possession of the facility or real property encumbered by the security interest, the lender: (1) exercises decision-making control over the environmental compliance of the facility; or (2) exercises control at a level comparable to that of a manager of the facility, such that the person has assumed or manifested responsibility (a) for the overall management of the facility encompassing day-to-day decision making with respect to environmental compliance, or (b) over all or substantially all of the operational functions (as distinguished from financial or administrative functions) of the facility other than the function of environmental compliance.

CERCLA lists several actions commonly taken by lenders that do not constitute participation in management, including, among others, the following:

- Holding, abandoning or releasing a mortgage or other security interest
- Including covenants, warranties or other terms and conditions in loan documents that relate to environmental compliance
- Monitoring or enforcing the terms and conditions of loan documents
- Monitoring or inspecting a facility
- Requiring a borrower to conduct remediation or other response actions at a facility
- Amending terms and conditions of loan documents or exercising forbearance

LENDER LIABILITY AND FORECLOSURE

A lender may foreclose on collateral without becoming subject to CERCLA liability provided that the lender did not participate in the management of the facility prior to foreclosure, and after foreclosure, seeks to sell, re-lease (in the case of a lease finance transaction) or otherwise divest the facility "at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements." Thus, after foreclosure, the lender may: sell, re-lease or liquidate the facility; maintain business activities; wind up operations; undertake certain response actions; or take any other measure to preserve, protect or prepare the facility for sale or disposition without being subject to CERCLA liability as an owner or operator.

At a minimum, before foreclosing, a lender should first review the loan file to determine what environmental due diligence the borrower conducted at the time the borrower acquired the property. Although not specifically directed at lenders, lenders may seek to obtain additional protection from CERCLA liability under the "innocent landowner" or "*bona fide* prospective purchaser" exceptions, by making "all appropriate inquiries" before foreclosing. In order to satisfy the all appropriate inquiries rule, the lender should engage a qualified environmental consultant to perform a Phase I Environmental Site Assessment in accordance with

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ASTM International Standard E1527-05 (which is the industry standard deemed by the U.S. Environmental Protection Agency ["EPA"] to satisfy the all appropriate inquiries rule).

If, after foreclosure, a CERCLA action were brought against a lender, the lender bears the burden of establishing that it qualifies for liability protection. The analysis can be intensely factual. Consequently, a lender should carefully document its efforts to market or sell the real property. In addition, a lender should avoid expanding the operation of an ongoing business or taking other actions that suggest the lender intends to hold title to the property as an owner. EPA guidance uses a bright line test stating that a foreclosing lender qualifies for liability protection if it lists the facility or real property for sale within 12 months of foreclosure. Satisfying this "bright line" test, however, is not a condition precedent to obtaining the benefit of the exemption. But it is the simplest and most cost-effective method of ensuring the applicability of the liability protection after foreclosure.

At the time of foreclosure, lenders frequently arrange for an affiliated entity—such as a newly formed subsidiary or special purpose entity—to take title to the real property. In many cases, the lender entity will continue to hold the security instrument when the affiliated entity takes title. While there may be title, liability protection or other important reasons for this arrangement, the affiliated entity might not benefit from CERCLA's lender liability protection because it is not a "lender" under CERCLA. A lender is defined under CERCLA as "any person…that makes a *bona fide* extension of credit to or takes or acquires a security interest from a nonaffiliated person." While one might argue that the affiliated entity is taking title to the real property to preserve the value of the affiliated lender's collateral, we have found no authority suggesting that Congress considered such an arrangement when it enacted the applicable amendments to CERCLA. Nor have we identified any judicial opinions directly addressing this issue. Consequently, if a lender wants to be sure that an affiliated entity will qualify for the lender liability protection under CERCLA, it should assign the loan to the affiliated entity prior to the time that entity takes title to the real property.

OTHER CONSIDERATIONS

Lenders should also consider whether they have liability exposure under applicable state law. While every state has CERCLA-like legislation that addresses the liability of PRPs for releases of hazardous substances, the breadth of such legislation varies considerably from state to state. The scope and availability of lender liability protections under state law may vary considerably from the exceptions available under CERCLA. For instance, under Massachusetts law, a foreclosing lender is expressly required to take certain actions if it obtains knowledge of a release of hazardous substances after it takes title to real property. In addition, under the Massachusetts lender liability exceptions, there is a presumption after foreclosure that the lender acted diligently to divest itself of ownership or possession of the property during the first 36 months after the lender acquired ownership. After the 36-month anniversary of foreclosure, the burden of proof shifts to the lender to demonstrate that it acted diligently to divest itself of ownership. Consequently, lenders should work with counsel familiar with the environmental laws of the state in which the subject property is located to evaluate the lender's potential liability exposure under CERCLA and state law before the lender takes a security interest in or forecloses on such property.

In addition to evaluating a lender's potential exposure to federal and state hazardous waste liabilities, lenders should conduct environmental due diligence before issuing a mortgage loan or taking a security interest in real property. Environmental due diligence allows a lender to evaluate whether there are environmental liability or compliance issues that could: (1) affect the borrower's ability to repay the loan; (2) harm the value, marketability or future use of the collateral; (3) impair the marketability of the loan; (4) financially drain the borrower's ongoing operations; or (5) create a reputational risk to the lender by associating the lender with a heavily contaminated site. <