DISTRESSING ASSETS:
LENDERS AND ENVIRONMENTALLY-IMPACTED COLLATERAL

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This article will focus on the complicating issues that arise for lenders when property held as collateral is, or is suspected of being, impacted by environmental concerns. Impacts may occur in various ways: spills or releases of contaminants through business operations (such as underground storage tanks or dry cleaning plants); the presence of contamination from historic operations at a site; migration of contaminants onto the site from offsite sources; or hazardous substances incorporated in building materials (such as asbestos) or components (such as PCBs).

Environmentally-related concerns can adversely impact not only the value of the collateral held, but also the ability of the lender to dispose of the collateral, if it should prove necessary, to cover loan losses. Lenders also face the possibility of exposure to environmental liability under statutory provisions that can impose strict, joint and several liability based on a lender's status with respect to a contaminated site, not because it has engaged in wrongdoing. That type of "status liability" has the potential of exceeding the value of the collateral from which the liabilities arise. Lenders arguably enjoy the best insulation from such liabilities of any person in the universe of "potentially responsible parties" under environmental statutes. However, this insulation may be less than meets the eye. The statutory defenses that provide the insulation do not provide comprehensive protection, and there are no bright-line standards to provide comfort to a lender that it has performed the required actions necessary to qualify for the protection that may be available.

MANAGEMENT OF ENVIRONMENTAL RISKS AND LIABILITIES

As a result of concerns posed by environmental risks, many lenders have established an environmental risk policy to help guide lending decisions. These policies can involve the following components:

- A process to identify and evaluate environmental risk when a loan is originated. Lenders should look at how environmental costs and other obligations may adversely impact the borrower's ability to repay the loan. Lenders should also look at properties being considered as collateral for the loan, particularly where operations of potential concern have been conducted or are being conducted. Lenders should also be concerned whether collateral is impacted by historical contamination. This process includes establishing due diligence protocols and other guidelines for appropriate inquiry into the uses of the property and for other protective actions. The process will need to satisfy "all appropriate inquiry" requirements in order for lenders to avail themselves of certain statutory defenses available under federal law, as discussed below.

- A process to monitor the environmental status of the borrower's operations and of the collateral throughout the life of the loan. Loan documents will typically have provisions

- requiring the borrower to report environmental claims or events to the lender. Loan documents will typically also have provisions that allow lenders to perform, at borrower's expense, additional assessment of collateral through the life of the loan many times usually following a specified triggering event.

- A process to reconsider and reanalyze environmental risk associated with collateral securing a non-performing loan. This process, which is addressed in more detail below, includes consideration of alternative strategies for recovering the value of collateral both without foreclosure and utilizing foreclosure.

- A process for addressing risks post-foreclosure. This process is also addressed in more detail below and will apply should the lender decide to exercise its security interest and foreclose on the collateral that secures a non-performing loan.

A. Applicable Environmental Laws

The federal Comprehensive Environmental Response, Compensation, and Liability Act *("CERCLA")* provides a broad legal framework that creates potential liability for the cost of cleaning up property contaminated with hazardous substances. Persons that may be potentially responsible for liability under CERCLA (also referred to as Superfund) include:

- the current owner and/or operator of a facility;

- an owner and/or operator of a facility at the time of disposal of any hazardous substances;

- a person who arranged for the disposal or treatment of hazardous substances, or arranged for transportation of hazardous substances for disposal or treatment; and

- a person who accepts hazardous substances for transport to a site and selects the site.

Liability under CERCLA is strict (without fault being necessary) and is joint and several, which can expose a responsible party to the entire cost of the cleanup even if that party is not the only responsible party. Actions may be brought by the government or by third parties.

Of particular interest to lenders is the "secured creditor exemption" under CERCLA, discussed in more detail below. The secured creditor exemption can provide qualifying lenders with an exemption from status as an "owner or operator" even in situations where the lender forecloses and takes title to a property.

CERCLA also provides a limited defense to liability for certain qualifying purchasers of property with known contaminants. One of the requirements necessary in order to qualify as a "bona fide prospective purchaser" is that the person conduct "all appropriate inquiry" ("*AAI*") prior to purchasing, or taking title to, property. The AAI standard will require that an appropriately-scoped Phase I environmental site assessment be conducted prior to property acquisition. There are also continuing obligations that an owner must then meet during its ownership to maintain bona fide prospective purchaser status.

The federal Resource Conservation and Recovery Act *("RCRA")* governs hazardous waste from the time it is generated through storage, transportation, and ultimate disposal. Underground storage tanks ("*UST*s") are regulated under RCRA. USTs will many times be part of the collateral for loans not only for gas stations and convenience stores, but also for other property with industrial or commercial operations. Lenders need to be concerned about compliance with applicable laws regarding the installation, operation, and removal of USTs. The federal secured creditor exemption is also available to provide qualifying lenders with an exemption from status as an "owner or operator" of USTs under RCRA.

While other federal environmental laws can also create liability, the status liability provisions of CERCLA and RCRA are of particular concern to lenders. Additionally, many states have adopted statutes that parallel the status liability approach in CERCLA and RCRA and can impose additional requirements of concern to lenders.

B. Secured Creditor Exemption

Section 101(20) of CERCLA provides a liability exemption for secured interest holders, excluding from the definition of an "owner or operator" lenders that without participating in the management of a facility hold indicia of ownership primarily to protect a security interest in the facility. (This exclusion from liability does not extend to the other statutory "status" categories under which a lender could incur liability as a responsible party.) CERCLA, as originally drafted, did not, however, provide for an explanation of the scope of that liability exemption.

The Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996 (the "*1996 Amendments*") added language to CERCLA intended to clarify the scope of the liability exemption for lenders. The 1996 Amendments also provided a secured creditor exemption under the provisions in RCRA that relate to owners and operators of USTs.

The 1996 Amendments attempted to address two important questions relating to the availability of the Secured Creditor Exemption: (1) what is "participation in management," which is a particular concern to lenders pre-foreclosure; and (2) whether foreclosure would render a lender an "owner or operator" for status liability purposes.

1. Participation in Management

A lender must not participate in the management of a facility pre-foreclosure if it expects to qualify for the federal secured creditor exemption. For purposes of the secured creditor exemption, the term "participate in management" includes actually participating in the management or operational affairs of a property. Merely having the opportunity to influence or control operations is not sufficient; the lender must actually exercise control.

The language of the secured creditor exemption provides that a lender will be considered to have participated in management if, while the borrower is still in possession of the property, the lender does any of the following:

- exercises decision-making control over the environmental compliance related to the property, such that the lender has undertaken responsibility for the hazardous substance handling or disposal practices related to the property; or

- exercises control at a level comparable to that of a manager of the property, such that the lender has assumed or manifested responsibility:

    - for the overall management of property encompassing day-to-day decision making with respect to environmental compliance; or

    - over all, or substantially all, of the operational functions (as distinguished from financial or administrative functions) of the property other than the function of environmental compliance.

The language of the secured creditor exemption also provides that a lender can perform the following acts which do not rise to the level of participating in management:

- holding a security interest or abandoning or releasing a security interest;

- including in the loan documents a covenant, warranty, or other term or condition that relates to environmental compliance;

- monitoring or enforcing the terms and conditions of the loan documents;

- monitoring or undertaking inspections of the property;

- requiring a response action or other lawful means of addressing the release or threatened release of a hazardous substance in connection with the property prior to, during, or on the expiration of the term of the loan;

- providing financial or other advice or counseling in an effort to mitigate, prevent, or cure default or diminution in the value of the property;

- restructuring, renegotiating, or otherwise agreeing to alter the terms and conditions of the loan, or exercising forbearance;

- exercising other remedies that may be available under applicable law for the breach of a term or condition of the loan; or

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- conducting a response action under §107 of CERCLA under the direction of an on-scene coordinator appointed under the National Contingency Plan.

The state counterparts of the federal statutes may also provide a secured creditor exemption. Those state requirements may differ from the requirements of the federal secured creditor exemption, so compliance with the federal provisions will not guarantee compliance with state provisions.

An additional issue related to pre-foreclosure actions by a lender involves the rights it holds under the various documents that make up the loan documents. Although it would be expected that a secured lender is afforded broad rights under the documents that grant the security interest, this is not always the case. Lenders are well advised to have counsel review all relevant loan documents and advise lenders about rights they may have to enter the property, whether to perform subsurface investigation or to undertake environmental response actions.

2. Post-Foreclosure Requirements

In order for a lender to preserve its secured creditor exemption under federal law post-foreclosure, the lender must not have "participated in management" of the facility prior to foreclosure and it must divest itself of the property at the earliest practicable, commercially reasonable time on commercially reasonable terms taking into account market conditions and legal and regulatory requirements. While CERCLA does not specifically address the term "commercially reasonable," current EPA guidance indicates that the lender must attempt to sell, re-lease, or otherwise divest itself of the property within 12 months of foreclosure. If the lender meets this standard, then it may generally maintain business activities; wind up operations; and take actions to preserve, protect or prepare the property for sale so long as the lender lists the property with a broker or advertises it for sale in an appropriate publication. Although those permissible activities sound a lot like "participation in management," there are at least two cases where courts determined that a "no participation in management" requirement also extends post-foreclosure. The lender may also be able to qualify as a "bona fide prospective purchaser" provided that it can demonstrate that it conducted "all appropriate inquiry" into the property prior to foreclosure and subsequently took the necessary steps to stop any continuing release; prevent any threatened future release; and prevent exposure to previously released hazardous substances.

Again, the requirements of the secured creditor exemption in state statutes may differ from those in CERCLA and RCRA.

DISPOSITION OF ENVIRONMENTALLY-IMPACTED COLLATERAL BY LENDERS

If attempts to restructure the loan terms through a workout are unsuccessful and the lender wants to salvage value from the collateral it holds (as opposed to abandoning its interest in the collateral due to concerns about exposure to environmental liabilities), it will be faced with a decision of how to proceed.

As earlier noted, lenders should have a process in place for analyzing the environmental risks of non-performing loan collateral. Before deciding how to proceed with collateral from non-performing loans, the lender should go through an updated due diligence process. If environmental risk issues were considered in the original loan underwriting process and in the subsequent loan management process, the lender will probably not be faced with environmental surprises from the updated due diligence. If, however, it is determined that the cost of addressing environmental problems exceeds the value of the collateral, the lender will want to walk away from its security interest. Alternatively, if the cost of addressing the environmental problems is less than the collateral is worth, the asset has net value, at least from the standpoint of an environmental analysis. The lender will then want to determine how best to capture that value and minimize its loan loss.

By acquiring a property through foreclosure or other means, such as through the lender tendering the deed in lieu of foreclosure, the lender places itself in the chain of title for contaminated property. If the lender qualifies for the secured creditor exemption, it creates an anomalous situation where the lender holds title to property, but is not considered an "owner" of that property for status liability purposes. A lender may, nevertheless, inadvertently step into unexpected obligations by foreclosing on property. One example is the affirmative requirements imposed on a foreclosing lender under Texas statutory and regulatory provisions relating to USTs. Additionally, foreclosing lenders can be hit with the cost of storm water control obligations where they have foreclosed on uncompleted property developments. Also, water intrusion into structures can require action, and related cost, to avoid mold contamination and preserve the value of the foreclosed collateral.

Consequently, lenders may want to consider strategies that do not involve taking title to property, whether through foreclosure or other means, so they can effectively avoid both issues associated with ownership and concerns as to whether they have satisfied the requirements necessary for compliance with the secured creditor exemption. In some cases, a lender faced with environmentally-impacted collateral may be able to forego foreclosure and instead sue the debtor on the underlying note or the guarantor of the secured debt on its guarantee so the lender does not become the owner of the property covered by its deed of trust lien.

A. Recovering Value from Collateral – Pre-foreclosure Considerations

Strategies a lender may consider that do not require it to foreclose on property, or at least minimize its exposure from foreclosure, include the following:

1. <u>Sale of Note</u>

One approach is to sell the underlying note and assign the related security interest in the collateral to a third party, thereby avoiding potential liability and other issues that could arise by foreclosing on the collateral.

2. <u>Short Sale</u>

The lender may also facilitate a short sale of the collateral by the defaulting borrower directly to a third-party purchaser.

3. Receivership

Receivership offers a way for a lender to have an unaffiliated third party, under supervision of the court, address environmental issues at the property that serves as loan collateral and sell the property, without the lender being involved in management of the property.

4. Assignment to Special Purpose Entity

In order to better insulate itself from environmental liability, lenders may choose to assign the loan and its lien to an affiliated special purpose entity in advance of foreclosure. That strategy attempts to isolate in the special purpose entity liability that may arise from the environmental conditions of the property acquired through foreclosure.

B. Recovering Value from Collateral – Post-forelosure Considerations

In the event the lender forecloses on property, rather than pursuing one of the avenues noted above, the lender will need to actively market that REO property in order to qualify for the post-foreclosure protection offered by the secured creditor exemption under federal and state law.

A number of environmentally-related matters that selling lenders and purchasing investors may want to consider in negotiating their deals are discussed below.

1. Due Diligence

Before lenders foreclose, they should understand the then-current condition of the collateral and risks and liabilities that may arise out of their ownership of REO property. That will usually involve obtaining an updated environmental assessment, which may or may not be performed using the AAI standards.

2. Pricing.

A second issue is pricing the REO property. In determining what to offer for an REO property, the buyer will seek to adjust the price by an amount to reflect both the cost of environmental remediation and the perceived risk it would be taking on. Unless the lender understands the site conditions, and in particular the potential remediation strategies and cost ranges related thereto, the lender can be foregoing significant recovery in pricing the property for sale.

In many cases, the lender cannot afford to, or does not otherwise want to, physically address the environmental issues at a property. Where regulatory closure issues remain open, prospective buyers may shy away from bidding on the property. One technique successfully used for a bankruptcy trustee client to assist in the marketing process for contaminated property was to create, with assistance of an environmental consultant, an analysis of the available strategies to achieve regulatory closure and ranges of costs associated with those strategies. The analysis served as a way to help potential buyers understand that regulatory closure could be accomplished for a reasonable cost and in a reasonable time frame at that particular contaminated site.

3. Risk Allocation

The contractual allocation of environmental risks and liabilities is a third important issue in deal negotiations. A lender will want the buyer to assume responsibility for environmental conditions impacting property being sold.

Where a lender sells property acquired through foreclosure on an "as is" and "with all faults" basis, the lender should obtain a release of liability from the buyer from all claims, including environmentally-related claims, which would explicitly bar the buyer from seeking cost recovery from the selling lender.

Lenders may also request contractual indemnification from the buyer. The purpose of indemnification is to protect the lender from third-party claims relating to the property sold, since the release would bar first-party claims by the buyer. Among other things, indemnification would provide protection to seller against cost recovery claims from subsequent purchasers that will not be bound by the release provided to the lender by the original buyer.

4. Environmental Insurance

If a buyer is not willing to provide an indemnity, or if an indemnity is of limited value because of the buyer's lack of financial wherewithal, the lender may want to consider an environmental insurance policy. Insurance can allow environmental risks to be allocated to an entity that is not a party to the purchase transaction and that has demonstrated financial wherewithal.

5. Other Matters

The secured creditor exemption requires the lender to make commercially reasonable efforts to divest itself of the property at the earliest practicable, commercially reasonable time. Because the lender's compliance with the requirements will necessarily be considered in hindsight, the lender is well advised to document its efforts to market the property.

WRAP UP

With the secured creditor exemption, lenders are arguably better protected than other parties that similarly may be subject to status liability under federal and state environmental laws. Nevertheless, that protection is not comprehensive, and there are a number of potential pitfalls that can make the secured creditor exemption unavailable. Lenders are well advised to establish an environmental risk policy that will provide guidance concerning environmental issues from loan inception throughout the life of a loan and in the event the borrower defaults on the loan.

A lender will want to undertake pre-workout due diligence before deciding how to address collateral relating to non-performing loans. As it moves forward, the lender may choose a strategy that will keep it out of the chain of title for the property. If the lender chooses instead to foreclose, it will want to consider carefully the structure of the deal to protect itself from environmental legacy issues related to the REO property it had held as collateral.

This article was prepared in August 2010 as a general discussion of the issues presented and is not to serve as, or to be relied upon as, legal advice. This article would not have been completed without the assistance of Michael Goldman and Erika Erikson, the author's colleagues at Guida, Slavich & Flores, P.C. The views expressed in the article are those of the author, and not of my law firm or its clients.

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