As If It Isn't Enough To Have a Non-Performing Loan: Dealing With Environmentally Impacted Distressed Assets

by John Slavich

I. Overview

As we are all painfully aware, the effects of the economic downturn that began in earnest in September 2008 have rippled through the United States economy. Lenders

are addressing the fallout from the sudden deflation of a property asset bubble.[1] Economic conditions have adversely impacted borrowers' ability to repay loans, and the value of assets held as collateral has tumbled.[2] A report in February 2010 by the Congressional Oversight Panel stated that since 2007, property values have fallen by an average of 40 percent, and of the $1.4 trillion in commercial mortgage debt to come due through 2014, about half of the loans are underwater with the borrowers owing more than their properties are currently worth.[3]

These estimates indicate that a massive amount of commercial mortgage debt (approximately equal to the size of the projected United States' fiscal deficit for 2010) is coming due for which refinancing is anticipated to be problematic because the value of collateral has materially declined.[4] Lenders once again have to address issues that have not presented a significant problem in Texas since the savings-and-loan/banking crisis of the 1980s.[5] Much of the hard-earned institutional knowledge from that era has dissipated in the interim, and a new generation has to grapple with the issues relating to distressed assets.

For the time being, lenders are dodging the threat of a tsunami of defaults, foreclosures, and distressed asset sales by following a policy, with the tacit approval of the regulators, commonly referred to as "extend and pretend" or "delay and pray," in which lenders extend loan terms to manage the number of defaults.[6] A popular phrase characterizing this strategy is "a rolling loan gathers no loss."[7]

This article will focus on the complicating issues that arise when property held as collateral by lenders is, or is suspected of being, adversely effected by environmental concerns. These adverse effects may occur in various ways: spills or releases of contaminants through business operations (*e.g.,* 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 (*e.g.,* asbestos) or components (*e.g.,* PCBs).

Environmentally related concerns can adversely effect not only the value of the collateral that the lender holds, but also the ability of the lender to dispose of the collateral, if it should prove necessary to do so to cover loan losses. Also of significant concern to lenders is the possibility of exposure to environmental liability under statutory provisions that can impose strict, joint, and several liability on a lender based on its status with respect to a contaminated site, and not because of any wrongdoing by the lender. That type of "status liability" has the potential to exceed the value of the collateral from which the liabilities arise. Lenders arguably enjoy the best insulation from these liabilities of any person in the class of "potentially responsible parties" under environmental statutes. However, this insulation may be less than meets the

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1 CONG. OVERSIGHT PANEL, COMMERCIAL REAL ESTATE LOSSES AND THE RISK TO FINANCIAL STABILITY 2 (Feb. 10, 2010), *available at* http://cop.senate.gov/documents/cop-021110-report.pdf.

2 *Id.*

3 *Id.*

4 *Id.*

5 *Id.* at 16.

6 *Id.* at 102.

7 Robert Knakal, *A Rolling Loan Gathers No Loss*, N.Y. OBSERVER, Sept. 15, 2009, *available at* http://www.observer.com/2009/real-estate/rolling-loan-gathers-no-moss.

eye. The statutory defenses that provide the insulation do not provide comprehensive protection; and a lender does not have any bright-line standards to follow in its efforts to perform the required actions necessary to qualify for the protections that may be available.

This article will briefly consider administrative processes that lenders can use to manage environmental risks and liabilities. It will then look at liabilities that can potentially arise under the various environmental statutes and defenses that may be available to lenders. Finally, it will consider issues that arise in connection with the disposition of environmentally-challenged collateral that will be of concern to lenders and to potential purchasers of that collateral.

II. Environmental Risks and Liabilities

Lenders tend to operate at the conservative end of the risk spectrum, and their best-case scenario is having the loan principal repaid with interest. Consequently, when considering the risk/reward equation, lenders generally take the position that a limited potential for reward is appropriately balanced by a lower tolerance for risk.

In originating a loan, lenders focus on repayment risk including risks that may arise out of the borrower's operations and assets. One way lenders manage their financial risk exposure is by taking an interest in collateral as security for the borrower's repayment of the loan.

As a result of concerns posed by environmental risks, many lenders have established an environmental risk policy to help guide lending decisions. These policies should 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 effect the borrower's ability to repay the loan. Lenders should examine properties that they are considering as collateral for the loan, particularly when operations of potential concern have been conducted or are being conducted. Lenders should also be concerned with whether historical contamination adversely effects the collateral. This process includes establishing due-diligence protocols for appropriate inquiry into the uses of the property to satisfy the "all appropriate inquiry" component of certain statutory defenses available under federal law, as discussed later in this article.
- A process to monitor the environmental status of the borrower's operations and 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 also usually include provisions that allow lenders to perform, at the borrower's expense, additional assessments of collateral through the life of the loan, generally following a 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 later in this article, includes consideration of alternative strategies for recovering the value of collateral both with and without foreclosure.
- A process for addressing risks post-foreclosure. This process is also addressed in more detail later in this article 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

Some of the environmental laws that drive lenders' risk concerns are summarized below to provide a framework for later analysis in this article.[8]

1. Federal Law

a. Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)

The federal CERCLA[9] statute 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.[10]

Liability under CERCLA is strict (without fault being necessary) and 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.[11] The government or third parties may bring cost-recovery actions under CERCLA.[12]

Of particular interest to lenders is the "secured creditor exemption" under CERCLA, discussed in more detail in Subsection B of this Section II., below. The secured-creditor exemption can provide qualifying lenders with an exemption from status as an "owner or operator" even in situations in which 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.[13] One of the requirements necessary 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.[14] The AAI standard will require that an appropriately scoped Phase I environmental site assessment be

8 The summary overview of a complex environmental legal area is not intended as a comprehensive discussion of applicable law, nor to serve as guidance for any particular situation.

9 42 U.S.C. §§ 9601–9675. (2010).

10 42 U.S.C. § 9607(a) (2010).

11 *Id.*

12 *See* 42 U.S.C. § 9659 (2010).

13 42 U.S.C. § 9601(40) (2010); 42 U.S.C. § 9607(r)(1) (2010).

14 40 C.F.R. § 312.1(b)(1)(ii) (2010).

conducted prior to property acquisition.[15] The owner must also meet continuing obligations during its ownership to maintain bona fide prospective purchaser status.[16]

b. The Resource Conservation and Recovery Act (RCRA)

Another federal law that can impose liability as a result of contamination is RCRA. [17] RCRA governs hazardous waste from the time it is generated through storage, transportation, and disposal. Under certain conditions, RCRA also requires the cleanup of property contaminated with hazardous waste. The United States Environmental Protection Agency (EPA) has delegated to many states the authority to establish and administer their own RCRA programs.

Of particular importance to lenders is the fact that underground storage tanks (USTs) are regulated under RCRA and its state counterparts. 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.[18]

c. Other Federal Environmental Laws

Other federal environmental laws, such as the Clean Air Act, Clean Water Act, and the Toxic Substance Control Act, can also create liability.[19] The potential for liability under these laws will depend upon the type of operations conducted at a property and other factors.

2. State Law

Many states have adopted statutes that parallel the previously noted federal statutes and include similar provisions, such as the secured-creditor exemption. When the administration of federal programs is delegated to a state, the state's laws and regulations must be at least as stringent as federal provisions. States are not, however, limited only to addressing those provisions contained in the federal laws and regulations. State provisions can impose additional requirements that a lender must meet to receive protection under defenses and exemptions similar to those provided by the federal secured-creditor exemption discussed above.

The Texas rules governing USTs provide an example of a situation in which the state regulatory provisions are more stringent than both the federal and the state statutory provisions.[20] In particular, the Texas UST rules require a lender to begin removal of any underground tank from service within ninety days of the time that the lender

15 40 C.F.R. § 312.20 (2010).
16 42 U.S.C. § 9601(40) (2010).
17 42 U.S.C. §§ 6901–6908a (2010).
18 42 U.S.C. § 6991(b)(h)(9) (2010).
19 *See* 42 U.S.C. §§ 7401–7515 (2010), 33 U.S.C. §1251–1387 (2010), 15 U.S.C. §§ 2601–2608 (2010), respectively.
20 *See* 30 Tex. Admin. Code § 334 (2010).

foreclosures or becomes owner of the property.[21] In addition, under the Texas UST rules, the lender becomes liable as an owner or operator of the UST system located at that property at the end of twelve months if the lender has not sold the property by that time.[22]

B. Secured Creditor Exemption

As previously noted, lenders may incur status liability under CERCLA, RCRA, and their state counterparts by owning or operating a given property or satisfying another one of the categories that impose status liability. 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.[23] This exclusion from liability does not extend to the other statutory "status" categories under which a lender could incur liability as a responsible party. However, as originally drafted, CERCLA did not provide an explanation of the scope of that liability exemption.

The potential risk exposures under the status liability provisions of federal and state law were brought home to lenders in the *Fleet Factors* case.[24] The court in that case held that the CERCLA liability exemption for lenders was not available in situations in which the lender was in a position to participate in financial management of a facility to a degree indicating a capacity to influence a borrower's waste-disposal decisions, even if the lender did not actually exercise that control.

The EPA responded to lenders' concerns about potential liability exposure under the *Fleet Factors* case by promulgating a rule in 1992 interpreting the CERCLA liability exemption for lenders.[25] The rule clarified that actual conduct, rather than the ability to influence conduct, generally was necessary before liability would attach to lenders. However, the court in in *Kelley v. EPA* invalidated that EPA rule in 1994 on the grounds that the EPA exceeded its authority in promulgating a rule that extended beyond the bounds of the statute.[26] Following the *Kelley* decision, the EPA and the Department of Justice issued a joint policy stating that they would nonetheless follow the vacated rule. Congress subsequently amended CERCLA and RCRA when they adopted the Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996 (1996 Amendments). The 1996 Amendments, which are generally viewed as a codification of the concepts in the invalidated EPA rule, added language intended to clarify the scope of the liability exemption for lenders, as well as protections for fiduciaries discussed in Subsection C, below.[27]

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21 *See id.* § 334.15(d).

22 *See id.* § 334.15(h).

23 42 U.S.C. § 9601(20)(A) (2010).

24 United States v. Fleet Factors Corp., 724 F.Supp. 955 (S.D. Ga. 1988).

25 National Oil and Hazardous Substances Pollution Contingency Plan; Lender Liability Under CERCLA, 50 Fed. Reg. 18,344 (Apr. 29, 1992) (to be codified at 40 C.F.R. pt. 300).

26 Kelley v. EPA, 15 F.3d 1100 (D.C. Cir. 1994).

27 42 U.S.C. §§ 9601(20)(E), 9607(n)(5)(A)(i) (2010).

The 1996 Amendments expressly state that the secured creditor exemption applied to any person "that is a lender" that did not "participate in management."[28] The term "lender" was broadly defined to include:

- insured depository institutions;
- insured credit unions;
- a bank chartered under the Farm Credit Act of 1971;
- a leasing or trust company that is affiliated with an insured depository institution;
- any person making a bona fide extension of credit to or taking or acquiring a security interest from a nonaffiliated person;
- the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Agricultural Mortgage Corporation, or another entity that in a bona fide manner buys or sells loans or interests in loans;
- persons that insure or guarantee against a default in the repayment of an extension of credit, or act as surety with respect to an extension of credit to nonaffiliated persons; and
- persons that provide title insurance and that acquire a facility as a result of assignment or conveyance in the course of underwriting claims.[29]

In addition, the 1996 Amendments addressed two important questions relating to the availability of the Secured Creditor Exemption that were left open after the EPA's rule had been vacated: (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

28 42 U.S.C. § 9601(20)(E)(i) (2010).

29 *See id.* § 9601(20)(G)(iv).

— for 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.[30]

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
- conducting a response action under Section 107 of CERCLA under the direction of an on-scene coordinator appointed under the National Contingency Plan.[31]

Under the 1996 Amendments, the CERCLA provisions noted above were also extended to provide a secured-creditor exemption under the provisions in RCRA that relate to owners and operators of USTs.[32]

State statutes and regulations impose separate requirements to qualify under state counterparts of the federal secured-creditor exemption. These 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.

The statutory provisions of the Texas Solid Waste Disposal Act (TSWDA), which generally parallel CERCLA in scope, include a secured-creditor exemption that follows the exemption provisions in CERCLA, but relate to solid-waste facilities and hauling and disposal of solid waste, in contrast to the hazardous substances that CERCLA addresses.[33] Additionally, under the TSWDA, a lender can perform a response action if the Texas Commission on Environmental Quality (TCEQ) has approved the cleanup plan for that response action.

In contrast, the Texas statutory and regulatory provisions that provide a limit on the liability of lenders that hold a security interest in USTs or aboveground storage tanks, do not track the secured-creditor exemption provisions in the Texas Solid Waste Disposal Act noted above. The statutory provision that most closely relates to the secured creditor exemption provides that:

30 *See id.* § 9601(20)(F)(i)-(ii).
31 *See id.* § 9601(20)(F)(iv).
32 42 U.S.C. § 6991(b)(h)(9) (2010).
33 *See* TEX. HEALTH & SAFETY CODE §§ 361.701–361.702 (2010).

> "A lender that exercises control over a property before foreclosure to preserve the collateral or to retain revenues from the property for the payment of debt, or that otherwise exercises the control of a mortgagee-in-possession, is not liable as an owner or operator . . . unless that control leads to action that the [TCEQ] finds is causing or exacerbating contamination associated with the release of a regulated substance from a tank located on the property."[34]

The statute also recognizes that a lender can remove a tank from service or take corrective action at any time before foreclosure, but that the corrective action must be performed in accordance with requirements of the TCEQ.[35] For the limitation to apply to a lender after foreclosure, the statute requires that the lender "did not participate in the management of the aboveground or underground storage tank or real or personal property related thereto before foreclosure"; but does not explain what that participation may involve.[36]

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 expectation is not always fulfilled. Counsel for lenders should review all relevant loan documents before advising 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

a. Federal Law

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.[37] 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 twelve months of foreclosure.[38] 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.[39] Although

34 Tex. Water Code § 26.3514(c) (2010).

35 *See id.* § 26.3514(e).

36 *See id.* § 26.3514(f)(1).

37 42 U.S.C. § 9601(20)(E)(ii) (2010).

38 *See* U.S. Envtl. Prot. Agency Office of Enforcement Compliance Assurance, Superfund Frequently Asked Questions: Laws, Policy and Guidance, Question 5, www.epa.gov/compliance/resources/faqs/cleanup/superfund/laws-faqs.html (last updated Jan. 8, 2009) (referencing the EPA's 1997 policy that clarifies when the EPA intends to use the 1992 CERCLA Lender Liability Rule and its preamble in interpreting CERCLA's lender provisions).

39 42 U.S.C. § 9601(20)(E)(ii)(II) (2010).

those permissible activities sound much like "participation in management," in at least two cases courts determined that a "no participation in management" requirement also extends post-foreclosure.[40] 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.[41]

B. STATE LAW

The Texas Solid Waste Disposal Act provides similar protection to lenders that foreclose on contaminated property, but provides specific details on how the property is to be listed or advertised for sale, when the twelve-month period begins (*e.g.*, the date of foreclosure or when marketable title is acquired), and the actions the lender may take without becoming an owner or operator.[42] With respect to underground and aboveground storage tanks, the lender has an additional obligation to remove the tanks from service and complete any corrective action in response to any release from the tank.[43] Removal or corrective action must begin within ninety days from the time the lender becomes the owner of the property.[44] Furthermore, a lender becomes the owner of an underground or aboveground storage tank at the earlier of twelve months from when the lender forecloses or acquires marketable title, or when ownership is no longer held to protect a security interest even though the lender complied with the other requirements.[45]

3. JUDICIAL AUTHORITY

Only a handful of courts have analyzed a lender's pre- or post-foreclosure activities to determine whether it had lost the protections of the secured-creditor exemption. With respect to pre-foreclosure activities, courts have tended to recognize the exemption even when faced with facts that indicate some degree of participation in management. For instance, in *Z & Z Leasing v. Grayling Reel*, the court held that a lender did not participate in management when it had caused environmental surveys to be conducted on the property, had its environmental consultant remove underground storage tanks, and reported a release of hazardous substances to the State of Michigan.[46]

However, in *United States v. Mirabile*, the court denied a bank's motion for summary judgment that it had not participated in management based upon evidence that a loan officer was "always" present at the site, perhaps visiting the plant once a week.[47] In addition, the record contained evidence that the bank stated that the borrower would have to accept the day-to-day supervision if it wanted to continue operations

40 United States v. Fleet Factors Corp., 901 F.2d 1550, 1556 (11th Cir. 1990); United States v. McLamb, 5 F.3d 69, 72 (4th Cir. 1993).
41 42 U.S.C. § 9601(35)(A)(i) (2010).
42 TEX. WATER CODE § 26.3514(d) (2010); *see also* 30 TEX. ADMIN. CODE § 334.15 (2010).
43 TEX. WATER CODE § 26.3514(d) (2010).
44 *Id.*
45 30 TEX. ADMIN. CODE § 334.15(h) (2010).
46 Z & Z Leasing v. Grayling Reel, 873 F.Supp. 51, 54 (E.D. Mich. 1995).
47 United States v. Mirabile, 1985 WL 97, at *3 (E.D. Penn. 1985).

with bank funds. The loan officer also purportedly came to the site frequently and insisted on certain manufacturing changes and reassignment of personnel. In *New York v. HSBC USA, N.A.*, the State of New York claimed that the lender did not qualify for the exemption because the lender had obtained control over the operating funds of the borrower, which allegedly prevented the borrower from complying with its environmental obligations.[48] The lender purportedly instituted a lock-box arrangement with the borrower that permitted the lender to disburse funds on behalf of the borrower. Allegedly, the lender failed to make certain disbursements, which led to environmental non-compliance for the borrower. The matter ultimately settled, so the court did not opine on the situation presented.[49] Nonetheless, the case presents a not-uncommon set of facts in the context of the "participation in management" standard.

With respect to post-foreclosure activities, very little guidance is available on the issue of what constitutes commercially reasonable efforts by a lender to divest itself of property. Courts have found the secured-creditor exemption applies if the lender reasonably and promptly attempts to sell the property. For instance, in *Bancamerica Commercial Corp. v. Trinity Industries, Inc.*, the court concluded that the efforts were sufficiently prompt even though the lender rejected three offers that were less than the loan amount owed on the property, because soon after the lender took the deed in lieu of foreclosure, it listed the property with an agent who actively tried to sell the property.[50] However, in *United States v. Pesses*, the court found that the exemption was not available to a lender that took control of property post-foreclosure for over two years, took over responsibility for security of the property, hired people to clean up the plant and perform maintenance tasks, received assigned rent payments from the local development authority, and made arrangements to lease part of the facility to a new lessee when the debtor defaulted.[51] In another case, *XDP, Inc. v. Watumull Properties Corp.*, the court held that based upon the totality of the facts, the record presented a question of fact as to whether the lender was merely protecting its security interest or was actively involved in the management of the facility after it acquired the property.[52]

C. Limitation of Fiduciary Liability

The 1996 Amendments also provide that the liability of fiduciaries is expressly limited to the assets held in a fiduciary capacity, but only if an independent basis for liability other than ownership as a fiduciary or actions taken in a fiduciary role is not established.[53] A fiduciary may also be liable for its negligent action that "cause or

48 New York v. HSBC USA, N.A., No. 07-3160 (S.D.N.Y. filed May 30, 2007).

49 *See* Stephen C. Jones, Noah AnStraus & H. Hamilton Hackney, *CERCLA's 'Safe Harbor' Can Turn Rough for Unsuspecting Lenders*, (June 1, 2007), http://www.gtlaw.com/portalresource/lookup/wosid/contentpilot-core-401-7067/pdfCopy.pdf?view=attachment (last visited Nov. 7, 2010).

50 Bancamerica Commercial Corp. v. Trinity Indus., Inc., 900 F.Supp. 1427, 1457 (D. Kan. 1995).

51 United States v. Pesses, 1996 WL 143875, at *3–4 (W.D. Pa. 1996).

52 XDP, Inc. v. Watumull Prop. Corp., 2004 WL 1103023, at *18 (D. Or. 2004).

53 42 U.S.C. § 9607(n)(1) (2010).

contributes to the release or threatened release" of hazardous substances.[54] The Texas Solid Waste Disposal Act has similar provisions for fiduciaries.[55]

A fiduciary is any person acting for the benefit of another as a bona fide: (1) trustee; (2) executor; (3) administrator; (4) custodian; (5) guardian of estates or guardian ad litem; (6) receiver; (7) conservator; (8) committee of estates of incapacitated persons; (9) personal representative; (10) trustee acting under an indenture agreement, trust agreement, lease or similar financing agreement for debt securities, certificates of interest or certificates of participation in debt securities, or other forms of indebtedness as to which the trustee is not, in the capacity of trustee, the lender; or (11) representative in any other capacity that the EPA Administrator, after public notice, determines to be similar to the capacities listed above.[56]

The 1996 Amendments also establish a "safe harbor" for the purpose of describing actions that will not give rise to personal liability to the fiduciary if the fiduciary is:

undertaking or directing other persons to undertake a response action under Section 107(d)(1) of CERCLA or under the direction of a coordinator appointed under the National Contingency Plan;

- undertaking or directing another person to undertake lawful means of addressing a hazardous substance at the facility;
- terminating the fiduciary relationship;
- including in the terms of the fiduciary relationship a covenant, warranty, or other condition that relates to compliance with an environmental law or monitoring, modifying or enforcing a term or condition;
- monitoring or undertaking inspections of the facility;
- providing financial or other advice or counseling to other parties to the fiduciary relationship, including the settlor or beneficiary;
- restructuring, renegotiating, or otherwise altering the terms and conditions of the fiduciary relationship;
- administering as fiduciary, a facility that was contaminated before the fiduciary relationship began; or
- declining to take any of the actions described above, with the exception of those related to response actions.[57]

However, fiduciaries are specifically excluded from the benefits of the 1996 Amendments when a person: (a) is acting as a fiduciary with respect to a trust actively carrying on a business for profit, unless the trust was created due to the incapacity of a natural person; or (b) acquires ownership or control of a facility to avoid liability.[58]

III. Disposition of Environmentally Impacted Collateral By Lenders

At some point in time, the lender may need to consider the disposition of collateral it holds as security for non-performing loans. If attempts to restructure the loan

54 *See id.* § 9607(n)(3).
55 *See* TEX. HEALTH & SAFETY CODE §§ 361.65-52 (2010).
56 42 U.S.C. § 9607(n)(5)(A)(i)(I-XI) (2010).
57 42 U.S.C. § 9607(n)(4)(A)-(I) (2010).
58 *See id.* § 9607(n)(5)(A)(ii).

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 the lender considered environmental-risk issues 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 a 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 in which 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.[59] Foreclosing lenders can also be hit with the cost of storm-water-control obligations when they have foreclosed on uncompleted property developments.[60] Additionally, 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 foreclosure, or other means of taking title to property, so they can effectively avoid issues associated with both ownership and concerns as to whether they have satisfied the requirements necessary for compliance with the secured creditor exemption. One option is that a lender faced with environmentally-impacted collateral may forego foreclosure and instead sue the debtor on the underlying note, or the guarantor of the secured debt on its guarantee, so that 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:

59 30 Tex. Admin. Code § 334.15(d),(h) (2010).

60 *See* Texas Commission on Environmental Quality, *Storm Water Permits for Construction*, http://www.tceq.state.tx.us/nav/permits/wq_construction.html (last visited November 5, 2010).

1. SALE OF NOTE

One approach is to sell the underlying note and assign the related security interest in the collateral to a third party. A lender may explore the active market of investors interested in pursuing a variant of that transaction—referred to as "loan-to-own." In that case, a party acquires a note collateralized by property. If the loan is in default, the assignee can exercise its rights under the loan documents to foreclose on property that secures the note. By selling the note, the lender avoids potential liability and other issues that could arise by foreclosing on the collateral. Note, however, that the assignee of the note will not qualify for the secured-creditor exemption if it intends to acquire the property securing the note for investment.

2. SHORT SALE

The lender may also facilitate a short sale of the collateral by the defaulting borrower directly to a third-party purchaser. In that transaction, the lender will agree to take a loss on the loan in exchange for the sales proceeds from the sale of the collateral being applied against the outstanding loan balance. Under this strategy, the lender recovers some of the value that the collateral provides, but avoids being in the chain of title for the collateral sold.

3. RECEIVERSHIP

The loan documents may include, as one of the lender's remedies that arise upon default, a right to appoint a receiver for the collateral. Receivership offers a way for a lender to have an unaffiliated third party, under supervision of a 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. The downsides of receivership are that it involves additional administrative cost and that lenders effectively lose control of the collateral.

4. ASSIGNMENT TO SPECIAL-PURPOSE ENTITY

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-FORECLOSURE CONSIDERATIONS

If the lender forecloses on property rather than pursuing one of the avenues noted above, the lender will need to actively market the assets it acquires through foreclosure (many times referred to by lenders as real-estate-owned, or REO, property) in order to qualify for the post-foreclosure protection of the secured-creditor exemption under federal and state laws. With the onset of the economic downturn, many investors anticipated that lenders would be offering REO properties at significant discounts to the values the lenders show on their books, as was the case during the savings-and-loan/banking crisis in Texas in the 1980s. For a number of reasons, that anticipated result has not occurred, at least so far, during the current economic downturn. While lenders may be in the market to sell REO property (and be especially motivated for publicly reporting or regulatory purposes to sell as the end of their fiscal quarters ap-

proach), the spread between the lenders' asking price and the bid prices investors offer generally remains significant. That being stated, some deals involving REO property are being completed.

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 the risks and liabilities that may arise out of their ownership of REO property. This effort will usually involve obtaining an updated environmental assessment, which may or may not be performed using the AAI standards.[61]

A potential buyer may ask to utilize the lender's updated environmental assessment and also additional reports and other information from the lender's files. Unless the lender and its consultant agree to provide reliance on those reports, the buyer will not have any recourse against the lender's consultant if a problem arises that the consultant did not identify in the reports.

The bottom line is that buyers are well advised to use their own consultants to assess the collateral they plan to purchase. First of all, a report meeting AAI standards is necessary for a buyer's eligibility to utilize the bona fide prospective purchaser defense and other certain defenses under CERCLA.[62] Additionally, the buyer should consider whether it needs to look at environmental issues that are outside the scope of the AAI standards. Examples of matters excluded from the scope of an AAI report include analysis of wetlands and endangered-species issues, which will be of interest to buyers of undeveloped property, and asbestos, lead-based paint, and mold issues for properties with existing structures.

Investors looking to purchase distressed assets from lenders may make the business decision that if they are successful in negotiating a substantial discount on the purchase price, they may forego conducting their own environmental due diligence. Their rationale would be that the borrower would have also performed due diligence in acquiring the assets serving as collateral, and that the lender would have performed due diligence at the time the loan was made and before foreclosing, so the environmental risk should be minimal. That approach to risk analysis appears to be short-sighted for a number of reasons. The most obvious one is that the issues of concern are dynamic. Onsite and offsite conditions may have changed since previous due diligence was undertaken. An issue of particular concern is whether a borrower in financial distress may have ceased using its operating capital on environmental compliance or disposal of wastes, either of which could result in new environmental conditions affecting the property that serves as collateral. Even historic conditions may have changed because of exacerbating circumstances. Additionally, the fact that the loan-underwriting standards of many borrowers deteriorated in the years preceding the economic downturn is broadly acknowledged.[63] It is not reasonable to believe that environmental components of underwriting standards avoided that trend.

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61 *See* 40 C.F.R. § 312.20(b) (2010).

62 42 U.S.C. § 9607(q) (2010).

63 Sheila C. Bair, Chairman, Fed. Deposit Insurance Corp., On the Causes and Current State of the Financial Crisis before the Financial Crisis Inquiry Commission (Jan. 14, 2010), *available*

2. Pricing

A second issue is pricing the REO property. In determining what to offer for an REO property, the prospective buyer will seek to adjust the price by an amount to reflect both the cost of environmental remediation and the perceived risk associated with the property. Unless the lender understands the site conditions, and in particular the potential remediation strategies and cost ranges related to those strategies, 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 (including a Municipal Setting Designation[64]) 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. The prevailing practice to accomplish that goal is to sell property "as is" and "with all faults." Under Texas law, an "as is" sale is considered a recognition that the seller is not giving any representations or warranties regarding the property other than those relating to title or otherwise specifically set forth in the contract of sale.[65] An "as is" sale is intended to serve as an implicit bar to later claims by a buyer based upon breach of a representation or warranty and thereby removes the buyer's ability to bring a claim against seller for environmental conditions unless the seller has engaged in bad-faith practices, most notably fraudulent misrepresentation, concealment, or impairment of inspection.[66] The parties may also choose to clarify the scope of the risk allocation by specifically stating in the contract that at closing, as between seller and buyer, buyer will become solely responsible for all environmental conditions impacting the property.

An "as is" sale will not, however, bar a buyer from performing clean up at a property it has purchased on an "as is" basis and then suing responsible parties, including the lender, under applicable statutory cost-recovery provisions.[67] Consequently, in selling property acquired through foreclosure, the lender would be advised to require a release of liability from the buyer from all claims, including environmentally related

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at http://www.fdic.gov/news/news/speeches/chairman/spjan1410.html.

64 TEX. HEALTH & SAFETY CODE §§ 361.801–361.808 (2010).

65 Prudential v. Jefferson, 896 S.W.2d 156, 161 (Tex.1995).

66 *Id.* at 162.

67 *See* TEX. HEALTH & SAFETY CODE §§ 361.001–361.966 (2010); *see also* 42 U.S.C. § 9607 (2010); *see also* Bonnie Blue, Inc. v. Reichenstein, 127 S.W.3d 366, 369 (Tex. App.—Dallas 2004, no pet.).

claims, which would explicitly bar the buyer from seeking cost recovery from the selling lender.

Lenders may also request a buyer to provide contractual indemnification.[68] The purpose of indemnification is to protect the lender from third-party claims, since the release would bar first-party claims by the buyer. Among other things, indemnification would provide protection to the seller against cost-recovery claims from subsequent purchasers that will not be bound by the release provided to the lender by the original buyer. Buyers are, understandably, reluctant to provide indemnity protection to the lender-seller.

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. But environmental insurance may have other limitations that a lender selling REO property finds unattractive in comparison to a contractual indemnity from the buyer. An insurance policy will have specified coverage limits and a specified term. In contrast, indemnification provisions in the purchase and sale agreement can be negotiated so that it does not have a monetary limit on coverage or a time limit on the indemnity obligation. Additionally, environmental insurance policies have contractual exclusions that may limit their usefulness. One significant issue is an exclusion of coverage for clean-up costs for known pollution conditions, the so-called "burning building" for which insurers will not provide coverage. Finally, the cost of the policy may make it an unattractive alternative to contractual indemnification from the buyer.

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 these requirements will necessarily be considered in hindsight, the lender is well advised to document its efforts to market the property. In particular, it should document its reasoning for rejecting any offer for the property. One particular situation of concern may arise when a potential buyer makes an offer to the lender with a price that appears to be commercially reasonable, but has other aspects that are not acceptable to the lender. An example is when the lender insists upon a contractual indemnification from the buyer, but the buyer is unwilling to provide one.

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68 For a dated, but still useful, analysis of matters relating to contractual indemnification, *see* Parker and Slavich, *Contractual Efforts to Allocate the Risk of Environmental Liability: Is There a Way to Make Indemnities Worth More Than the Paper They Are Written On?*, 44 Southwestern L.J. 1349 (1991).

IV. CONCLUSION

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 lenders face 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 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, my colleagues at Guida, Slavich & Flores, P.C. The views expressed in the article are the author's, and not of Guida, Slavich & Flores, P.C. or its clients

John Slavich is a shareholder/principal in the law firm of Guida, Slavich & Flores, P.C. in Dallas. He has a diversified environmental law practice in which he provides strategic advice to clients on a broad range of environmental issues, including the environmental aspects of transactions, brownfields redevelopment, remediation matters, risk management, compliance matters, and climate change. Mr. Slavich's environmental practice is complemented by more than a decade of prior experience practicing corporate finance and transactional law.

Mr. Slavich received his law degree from Washington University in St. Louis, where he was a member of the Board of Editors of the Washington University Law Quarterly. *He earned his master of business administration degree from Southern Methodist University and his undergraduate degree from Earlham College. He was selected as* Best Lawyer's *2011 Dallas Environmental Lawyer of the Year.* Texas Monthly *magazine named him as a Texas Super Lawyer in their inaugural listing in 2003 and in each subsequent listing.*