JOHN SLAVICH

Guida, Slavich & Flores, P.C.

750 N. St. Paul Street
Suite 200
Dallas, Texas 75201
Ph: 214.692.0009
Fax: 214.692.6610

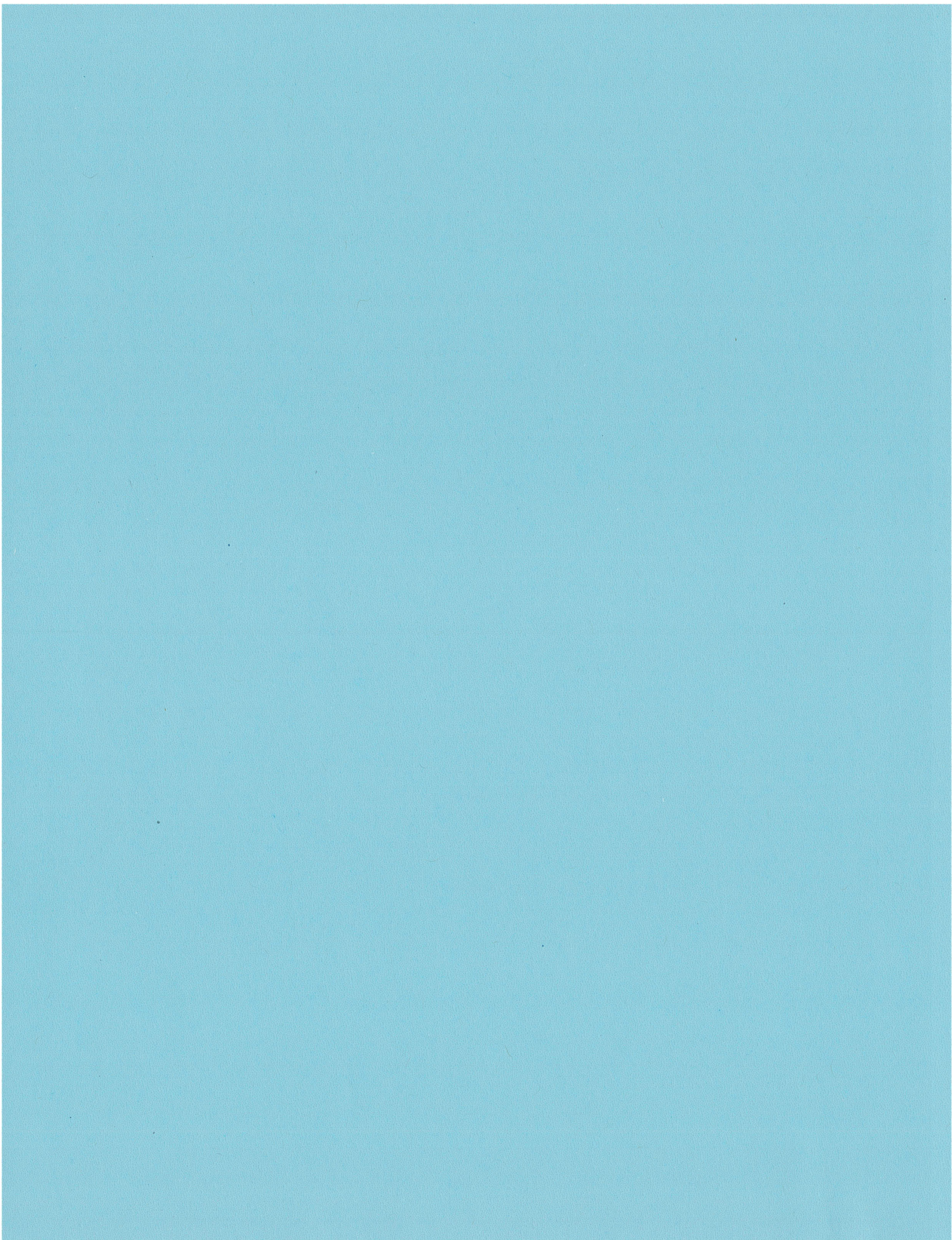
816 Congress Avenue
Suite 1500
Austin, Texas 78701
Ph: 512.476.6300
Fax: 512.476.6331

E-mail: slavich@gsfpc.com
Website: www.gsfpc.com

John Slavich is a shareholder in the law firm of Guida, Slavich & Flores, P.C. He has a diversified environmental law practice where he provides strategic advice to clients on a broad range of environmental issues, including the environmental aspects of transactions, remediation matters, brownfields redevelopment, compliance matters, and climate change. His clients have included public and private property owners, tenants, property purchasers, developers, investors and lenders. Mr. Slavich's environmental practice is complemented by more than a decade of prior experience practicing corporate finance and transactional law.

Mr. Slavich is a member of the State Bar of Texas and 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.

Texas Monthly magazine named him as a Texas Super Lawyer, and he is also listed in *The Best Lawyers in America*, *Chambers USA – Guide to America's Leading Business Lawyers*, and *Guide to the World's Leading Environmental Lawyers*.



DEALING WITH ENVIRONMENTALLY-IMPACTED FINANCIALLY-DISTRESSED ASSETS

JOHN SLAVICH
Guida, Slavich & Flores, P.C.
Slavich@gsfpc.com

State Bar of Texas
22ND ANNUAL TEXAS
ENVIRONMENTAL SUPERCONFERENCE
August 5-6, 2010
Austin, Texas

Copyright 2010 by John Slavich
All rights reserved.

TABLE OF CONTENTS

I. Overview 1

II. As If It Isn't Enough to Have a Non-Performing Loan 2

A. Applicable Environmental Laws 2

1. Federal Law 3

a. Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA") 3
b. The Resource Conservation and Recovery Act ("RCRA") 3
c. Other Federal Laws 4

2. State Law 4

B. Secured Creditor Exemption 4

1. Participation in Management 6
2. Post-Foreclosure Requirements 8

a. Federal Law 8
b. State Law 8

3. Judicial Authority 9

C. Limitation of Fiduciary Liability 10

III. Disposition of Environmentally-Impacted Collateral 11

A. Recovering Value from Collateral – Pre-foreclosure Considerations 11

1. Sale of Note 12
2. Short Sale 12
3. Receivership 12
4. Assignment to Special Purpose Entity 12

B. Recovering Value from Collateral Through Sale Following Foreclosure 12

1. Risk Allocation 13
2. Environmental Insurance 13
3. Due Diligence 14
4. Other Matters 15

IV. Wrap Up 15

V. Endnotes 16

DEALING WITH ENVIRONMENTALLY-IMPACTED FINANCIALLY-DISTRESSED ASSETS

John Slavich

I. OVERVIEW

As we are all painfully aware, the effects of the economic downturn that began in earnest in September of 2008 have rippled through the United States economy. Lenders are dealing with the fallout from the sudden deflation of a property asset bubble. Economic conditions have adversely impacted borrowers' ability to repay loans, and the value of assets held as collateral has tumbled. A report released several months ago by the Congressional Oversight Panel stated that since 2007, property values have fallen by an average of 40%, 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.

As a result, lenders are having to deal with issues that have not presented a significant problem in Texas since the 1980s. A lot of the hard-earned institutional knowledge from that era has dissipated in the interim, and a new generation is having to grapple with the issues relating to financially-distressed assets.

This paper will focus on the complicating issues that arise when property held as collateral by lenders 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 by the lender, but also the ability of the lender to dispose of the collateral, if it should prove necessary, 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, not because of any wrongdoing by the lender. 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 comfort a lender that it has performed the required actions necessary to qualify for applicable defenses.

This paper will briefly consider administrative processes 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

wrap up by looking at considerations that arise in connection with the disposition of environmentally-challenged collateral.

II. As If It Isn't Enough to Have a Non-Performing Loan

Lenders tend to operate at the conservative end of the risk spectrum. As I have been reminded time and again during deal negotiations, a lender's 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 reward potential is appropriately balanced by a lower risk tolerance.

In originating a loan, lenders will focus on repayment risk as well as the risks that may arise out of the borrower's operations and assets. Lenders typically manage those risks by, among other things, taking an interest in collateral as security for the borrower's repayment of the loan.

As a result of risks posed, many lenders establish an environmental risk policy to help guide decisions. The components of these policies can involve:

- 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. This process includes establishing due diligence protocols and other guidelines for appropriate inquiry into the uses of the property and for other protective actions to satisfy the "all appropriate inquiry" component of certain statutory defenses available under federal law, as discussed later in this paper.

- A process to monitor the environmental status of the borrower's operations and the collateral throughout the life of the loan.

- A process to reconsider and reanalyze environmental risk of non-performing loan collateral, including alternative strategies for recovering the value of collateral both without foreclosure and utilizing foreclosure.

- A process for addressing risks post-foreclosure.

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 paper.[1]

1. Federal Law

a. Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA")[2]

The CERCLA 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.

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 in Subsection B, 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 limited defenses to liability for certain qualifying purchasers of property with known contaminants.[3] 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[4] will require that an appropriate Phase I environmental site assessment be conducted prior to property acquisition. There are also continuing obligations that an owner must then meet during their ownership to maintain bona fide prospective purchaser status.[5]

b. The Resource Conservation and Recovery Act ("RCRA")[6]

Another federal law that can impose liability as a result of contamination is RCRA. RCRA governs hazardous waste from the time it is generated through storage, transportation, and ultimate disposal. Under certain conditions, RCRA also requires the cleanup of property contaminated with hazardous waste. Many states have been delegated 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.[7]

c. Other Federal Laws

Other federal environmental laws, such as the Clean Air Act, Clean Water Act and the Toxic Substance Control Act,[8] can also create liability. The potential for liability under these laws will depend upon the type of operations conducted at a property and other factors.

2. <u>State Law</u>

Many states have adopted statutes that parallel the federal provisions, including 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[9] provide an example of a situation where the state regulatory provisions are more stringent than both the federal and the state statutory provisions. 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 forecloses or becomes owner of the property.[10] In addition, under the Texas UST rules, the lender becomes liable as an owner or operator of that property at the end of twelve months if the lender has not sold the property by then. [11]

B. Secured Creditor Exemption

As previously noted, lenders may incur status liability under CERCLA, RCRA, and state-counterpart environmental laws by owning or operating a given property, or satisfying another one of the categories that impose status liability. Section 101(20) of CERCLA has always provided 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 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 potential risk exposure under the status liability provisions of federal and state law were brought home to lenders in the *Fleet Factors* case.[12] That case held that the CERCLA liability exemption for lenders was not available in situations where 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 United States Environmental Protection Agency ("*EPA*") responded to lenders' concerns about potential liability exposure under the *Fleet Factors* case by promulgating a rule in 1992 purporting to interpret the CERCLA liability exemption for lenders.[13] The rule clarified that actual conduct rather than the ability to influence conduct generally was necessary before liability would attach to lenders. The EPA's rule was, however, invalidated in 1994 in *Kelly v. EPA*[14] on the grounds that EPA exceeded its authority in promulgating a rule that extended beyond the bounds of the statute. Following the *Kelly* 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 (the "*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.[15]

The 1996 Amendments expressly state that the secured creditor exemption applied to any person "that is a lender" that did not "participate in management."[16] 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.[17]

In addition, the 1996 Amendments addressed two important questions left open after the EPA's rule had been vacated: (1) what is "participation in management"; and (2) whether foreclosure would render a lender an "owner or operator" for status liability.

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.[18]

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 §107 of CERCLA under the direction of an on-scene coordinator appointed under the National Contingency Plan.[19]

Under the 1996 Amendments, 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.[20]

State statutes and regulations also impose separate requirements in order to qualify under state counterparts of the federal secured creditor exemption. Those 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[21] that generally parallel CERCLA in scope include a secured creditor exemption that generally follows the exemption provisions in CERCLA, but relate to solid waste facilities in particular and hauling and disposal of solid waste in contrast to the hazardous substances covered by CERCLA. Additionally, a response action by the lender can also be performed under a cleanup plan approved by Texas Commission on Environmental Quality ("*TCEQ*").

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:

> "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 [TCEQ] finds is causing or exacerbating contamination associated with the release of a regulated substance from a tank located on the property."[22]

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 adopted by TCEQ.[23] In order for the limitation to apply to a lender after foreclosure, the statute requires that such 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 spell out what that participation may involve.[24]

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 agreement. 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. Counsel for lenders should review all relevant documentation 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

In order for a lender to preserve their secured creditor exemption post-foreclosure, the lender must not have "participated in management" of the facility prior to foreclosure[25] 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.[26] While CERCLA does not specifically address "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.[27] 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.[28] 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.[29]

b. State Law

The Texas Solid Waste Disposal Act provides similar protection to lenders that foreclose on contaminated property, but provides specific detail as to how the property is listed or advertised for sale, when the 12-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.[30] 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.[31] Removal or corrective action must begin within ninety days from the time the lender becomes the owner of the property.[32] Furthermore, a lender becomes the owner of an underground or aboveground storage tank at the earlier of 12 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.[33]

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 enforce the exemption even when faced with facts which 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 even though 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.[34]

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.[35] In addition, there was evidence that the bank stated that the borrower would have to accept the day-to-day supervision if it wanted to continue operations with bank funds. The loan officer purportedly also came to the site frequently and insisted on certain manufacturing changes and reassignment of personnel. In addition, recently in *New York v. HSBC USA, N.A.*, the State of New York claimed that the lender did not qualify for the exemption because it had obtained control over the operating funds of the borrower which allegedly prevented it from complying with its environmental obligations.[36] The lender had purportedly instituted a lock box arrangement with the borrower which permitted it 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. 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, there is also very little guidance and no bright line rule as to what constitutes commercially reasonable efforts by a lender to divest itself of property. Nonetheless, courts have found the secured creditor exemption applies if the lender reasonably 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 had 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 soon thereafter.[37] In *United States v. Pesses*, however, the lender lost the exemption where it took control of the 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.[38] In addition, in *XDP, Inc. v. Watumull Properties Corp.,* the court held that based upon the totality of the facts, there was a question of fact as to whether the lender

was merely protecting its security interest or actively involved in the management of the facility after it acquired the property.[39]

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 there is no independent basis for liability other than ownership as a fiduciary or actions taken in a fiduciary role.[40] The Texas Solid Waste Disposal Act has similar provisions for fiduciaries.[41] There is also a carve out of liability for the negligent action of the fiduciary that "cause or contributes to the release or threatened release" of hazardous substances.[42]

A fiduciary is specifically defined to include 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) representatives in any other capacity that the EPA Administrator, after public notice, determines to be similar to the capacities listed above.[43]

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 §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.[44]

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 in order to avoid liability.[45]

III. Disposition of Environmentally-Impacted Collateral

At some point in time, the lender may need to consider disposition of collateral it holds for non-performing loans. 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.

Foreclosure will put the lender 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. There are instances I am aware of where a lender inadvertently stepped into unexpected obligations by foreclosing on property. One example is the affirmative requirements noted earlier imposed on a foreclosing lender under Texas statutory and regulatory provisions relating to USTs. Additionally, foreclosing lenders have been 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 look to strategies that do not involve foreclosure so they can effectively avoid risk associated with ownership and without being concerned 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 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. There is an 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 goes into 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 use foreclosure to acquire the property for investment.

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. 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 provided by the collateral, but avoids being in the chain of title for the collateral sold.

3. <u>Receivership</u>

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 would appear to offer 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, without the lender being deemed to have participated in management of the property.

4. <u>Assignment to Special Purpose Entity</u>

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 Through Sale Following Foreclosure

In the event the lender forecloses on property, rather than pursuing one of the avenues noted above, the lender will need to actively market the collateral it has acquired in order to qualify for the post-foreclosure protection offered by the secured creditor exemption under federal and state law. With the onset of the economic downturn, many investors anticipated that lenders would be offering foreclosed properties at significant discounts to the values the lenders

show on their books. That was certainly the case during the savings and loan/banking crisis in Texas in the 1980s. For a number of reasons, that has not been the case, at least so far, during the current economic downturn. While lenders may be in the market to sell collateral (and be especially motivated for publicly-reporting or regulatory purposes to sell as the end of their fiscal quarters approach), the spread between the lenders' asking price and the bid prices investors offer remains significant. That being said, deals are getting done.

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

1. Risk Allocation

The allocation of environmental risks and liabilities is an important consideration in deal negotiations. The lender will, at a minimum, want to sell property on an "as is" basis. Under Texas law, an "as is" sale is considered a recognition that the seller is giving no representations regarding the property other than those relating to title or otherwise specifically listed in the contract of sale. An "as is" sale is intended to serve as a bar to later claims by a buyer based upon breach of a representation.

An "as is" sale will not, however, bar a purchaser from performing cleanup at a property it purchases on an "as is" basis and then suing responsible parties, including the lender, under the cost recovery provisions of the Texas Solid Waste Disposal Act.[46] Consequently, in selling property acquired through foreclosure, the lender would be expected to require a release of liability from the buyer, which would bar the buyer from making cost recovery, or other, claims against 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, since the release would bar the buyer's first-party claims. Among other things, indemnification would provide protection for cost recovery claims from subsequent purchasers that will not be bound by the release provided to the lender by the original buyer.

2. 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 a regulated 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 collateral may find 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 there is no monetary limit on coverage and no time limit on the indemnity obligation. Additionally, there are contractual exclusions in environmental insurance policies that may limit their usefulness.

One significant issue is a carve-out of coverage for cleanup 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.

3. Due Diligence

One investor looking to purchase distressed assets from lenders had told me that if his investment group was successful in negotiating a substantial discount on the purchase price, they probably would not be conducting their own environmental due diligence. His rationale was that the lender would have performed due diligence at the time the loan was made, and the borrower would have also performed due diligence in acquiring the assets serving as collateral. 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. There might have been changes in onsite and offsite conditions 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 and disposal of wastes, either of which could result in new environmental conditions affecting the property that serves as collateral. Even historic conditions may have increased because of exacerbating circumstances. Additionally, there is broad acknowledgment that the loan underwriting standards of many borrowers deteriorated in the years preceding the economic downturn. There is no reason to believe that environmental components of underwriting standards avoided that trend. Finally, not all environmental consultants out in the market are competent. There are a number of consulting firms whose work is immediately suspect to me, based on reports I have reviewed in the past.

Before lenders foreclose, they should understand the then-current condition of the property and risks and liabilities that may arise out of their ownership of the property. That will usually involve obtaining an updated environmental assessment.

A potential buyer may want 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 the reports, the buyer will have no recourse against the lender's consultant if there is a problem.

The bottom line is that buyers are well advised to use their own consultants to assess the collateral they plan to purchase. Not only is that a recognized best practice, but 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. Additionally, the buyer may need to look at environmental issues that are outside the scope of the AAI standards. Examples of excluded matters 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 for properties with existing structures.

4. 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. In particular, it should document its reasoning for rejecting any offer for the property. One particular situation of concern is where the lender is offered a price that appears to be commercially reasonable, but where there are other aspects of the offer that are not acceptable to the lender. One example would be where the lender insists upon a contractual indemnification from the buyer, but the buyer is unwilling to provide one.

In determining what to offer for a foreclosed property, the buyer will seek to adjust the price by an amount at least equal to the cost of environmental remediation. 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 selling the property. One technique we have used for our seller clients to assist in the marketing process is to create, with assistance of an environmental consultant, an analysis of the available strategies and ranges of costs associated therewith. The analysis, which is heavily caveated as to underlying assumptions and indicates that it is not intended as any type of representation or warranty concerning environmental conditions or remediation strategies, has served as a way for potential buyers to understand that there are ways in which regulatory closure can be accomplished at a contaminated site.

IV. WRAP UP

With the secured creditor exemption, lenders are arguably better protected than other parties that similarly may incur 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.

If it is necessary for a lender to dispose of environmentally-impacted collateral in exercising its remedies under the loan, there are a number of considerations relating to the risks taken on by foreclosing on the property, rather than utilizing a strategy that will keep the lender out of the chain of title for the property. Finally, if the lender chooses to foreclose, it will want to consider carefully the structure of the deal to protect itself from legacy issues related to the property it held as collateral.

This paper was prepared July 2010 as a general discussion of the issues presented and is not to serve as, or to be relied upon as, legal advice. This paper 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 paper are mine, and not of my law firm or its clients.

V. ENDNOTES

[1]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.
[2] 42 U.S.C. § 9601 *et seq.* (2010).
[3] 42 U.S.C. § 9601(40).
[4] 40 C.F.R. Part 312 (2010).
[5] 42 U.S.C. § 9601(40).
[6] 42 U.S.C. § 6901 *et seq.* (2010).
[7] 42 U.S.C. § 6991(b)(h)(9).
[8] 42 U.S.C. § 7401 *et seq.* (2010), 33 U.S.C. §1241 *et seq.* (2010), and 15 U.S.C. § 2601 *et seq.* (2010) respectively.
[9] 30 T.A.C. 334.
[10] 30 T.A.C. 334.15(d).
[11] 30 T.A.C. 334.15(h).
[12] *United States v. Fleet Factors Corp.*, 724 F.Supp. 955 (S.D. Ga. 1988).
[13] 57 Fed. Reg. 18,344 (Apr. 29, 1992).
[14] *Kelly v. EPA,* 15 F.3d 1100 (D.C. Cir. 1994).
[15] 42 U.S.C. §§ 9601(20)(E), 9607(n)(5)(A)(i).
[16] 42 U.S.C. § 9601(20)(E)(i).
[17] 42 U.S.C. § 9601(20)(G)(iv).
[18] 42 U.S.C. § 9601(20)(F)(i)-(ii).
[19] 42 U.S.C. § 9601(20)(F)(iv).
[20] 42 U.S.C. 6991(b)(h)(9).
[21] TEX. HEALTH & SAFETY CODE ANN. § 361.701 *et. seq*. (Vernon 2010).
[22] TEX. WATER CODE ANN. § 26.3514(c) (Vernon 2010).
[23] *Id*. § 26.3514(e).
[24] *Id*. § 26.3514(f)(1).
[25] 42 U.S.C. § 9601(20)(E)(ii).
[26] 42 U.S.C. § 9601(20)(E)(ii)(ll).
[27] *See* Question 5, EPA Office of Enforcement Compliance Assurance, "Superfund Frequently Asked Questions: Laws, Policy and Guidance," www.epa.gov/compliance/resources/faqs/cleanup/superfund/laws-faqs.html (last visited July 9, 2010. The guidance references EPA's 1997 policy that clarifies when EPA intends to use the 1992 CERCLA Lender Liability Rule and its preamble in interpreting CERCLA's lender provisions.
[28] 42 U.S.C. § 9601(20)(E)(ii)(ll).
[29] 42 U.S.C. § 9601(35)(A)(i).
[30] TEX. WATER CODE § 26.3514(d); *see also* 30 T.A.C. 334.15.
[31] TEX. WATER CODE § 26.3514(d).
[32] *Id.*
[33] 30 T.A.C. 334.15(h).
[34] *Z & Z Leasing v. Grayling Reel*, 873 F.Supp. 51, 54 (E.D. Mich. 1995).
[35] *United States v. Mirabile*, 1985 WL 97 at *3 (E. D. Penn. 1985).
[36] *New York v. HSBC USA, N.A*., (S.D. N.Y. No. 07-3160, 2007).
[37] *Bancamerica Commercial Corp. v. Trinity Industries, Inc*., 900 F.Supp. 1427, 1457 (D. Kan. 1995).
[38] *United States v. Pesses*, 1996 WL 143875, at *3-4 (W.D. Pa. 1996).
[39] *XDP, Inc. v. Watumull Properties Corp.,* 2004 WL 1103023, at *18 (D. Or. 2004).
[40] 42 U.S.C. § 9607(n)(1).
[41] *See* TEX. HEALTH & SAFETY CODE §§ 361.651-52.
[42] 42 U.S.C. § 9607(n)(3).
[43] 42 U.S.C. § 9607(n)(5)(A)(i)(I-XI).
[44] 42 U.S.C. § 9607(n)(4)(A)-(I).
[45] 42 U.S.C. § 9607(n)(5)(A)(ii).
[46]TEX. HEALTH & SAFETY CODE ANN. § 361.701 *et seq*. (Vernon 2010)*; see Bonnie Blue, Inc. v. Reichenstein*, 127 S.W.3d 366 (Tex. App.—Dallas 2004, no pet. h.).