Practical Considerations for Commercial Lenders Regarding Environmental Liability

by
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In the context of making a loan secured by commercial real estate, a lender is right to be concerned about environmental contamination at that property, and how it may impact potential liability for cleanup and the value of the property as collateral. According to a survey by Environmental Data Resources ("EDR"), one out of every ten banks involved in commercial real estate loans has experienced losses due to environmental issues over a one year period, with average losses of $1.2 million per loan.[2] This survey found that the smallest banks experienced the highest occurrence of environmental losses, with lenders with assets less than $1 billion experiencing almost 75 percent of loan losses due to environmental contamination. EDR concluded that one potential reason the smallest banks suffered the largest loan losses due to environmental contamination was because those banks performed less comprehensive environmental due diligence, and because smaller borrowers tended to walk away from contaminated sites because cleanup costs often exceeded their equity in the property.

This article reviews the specific factors on which liability for contaminated real property is based, as well as available defenses and exemptions, so lenders can spot transactional risks throughout the life of a loan, and make informed lending decisions.

The Wide Net of Environmental Liability

The primary environmental laws that concern most lenders in the context of property contamination are CERCLA[3], commonly known as "Superfund," and its Delaware equivalent, HSCA[4] . Liability under both laws is practically identical. CERCLA is typically directed at larger, more complex sites and is administered by the federal EPA. HSCA was enacted to enable the state environmental agency, the Department of Natural Resources and Environmental Control ("DNREC") to address contaminated sites not being addressed under the federal Superfund Program.

Under CERCLA and HSCA, liability is triggered if hazardous substances are present at a facility, there is a release or possibility of a release of those hazardous substances, response costs have been or will be incurred, and the entity at issue is a responsible party. Once a party is determined to be a "potentially responsible party" ("PRP"), it may be liable for cleanup costs, damages to natural resources, and the costs of certain health assessments, among others. CERCLA has four classes of liable parties, which include (1) current owners and operators of a facility, (2) past owners and operators of a facility at the time hazardous wastes were disposed, (3) generators and parties that arranged for the disposal or transport of the hazardous substances, and (4) transporters of hazardous waste that selected the site where the hazardous substances were brought. HSCA applies to the same categories of responsible parties, and adds an additional very broad catch-all category: any person who is responsible in any other manner for a release or imminent threat of release.

The key to liability is the "release" or suspected release of a "hazardous substance" that must be present at a property.[5] The operative terms are defined very broadly, encompassing a large number of compounds, substances, and mixtures as "hazardous substances," and defining a variety of passive and active activities as a "release." Of note, however, is that CERCLA's definition of hazardous substances specifically carves out petroleum, including crude oil or any fraction thereof not already listed as hazardous.[6]

Liability under CERCLA and HSCA is strict, joint and several. Liability is not based on a PRP's fault in causing a release, and it is joint and several, meaning one PRP can be responsible for all of a site's contamination even if it did not cause the release of hazardous substances. Liability is also retroactive, meaning that a PRP can be liable for activities that occurred before CERCLA or HSCA were enacted.

CERCLA and HSCA's unforgiving liability scheme gives rise to several concerns in the commercial lending arena: (i) whether the purchaser/borrower will be able to proceed with site development activities (and at what cost); (ii) whether the purchaser/borrower will be saddled with unexpected or prohibitive environmental remediation expenses; (iii) whether the site (loan collateral) will be impaired; and (iv) whether the lender will be confronted with potential liability for remediation costs. These issues, among others, are the foundation for much of what takes place in the environmental due diligence process.

Environmental Site Assessments – Protections and Value

How does a lender investigate a property for the presence of contamination? Lenders will typically require that the borrower conduct a Phase I Environmental Site Assessment, or "ESA," in accordance with EPA's All Appropriate Inquiry rule. If the borrower/prospective purchaser conducts due diligence and meets the "all appropriate inquiry" requirements in CERCLA or HSCA, liability may be limited or avoided under several statutory provisions. For the purchaser of property, and the lender, the ESA is a valuable tool in the due diligence tool box.

The first, and perhaps best known, of the statutory liability protections[7] is the "innocent landowner" defense. This protection applies to those persons who at the time of property acquisition did not know and had no reason to know that any hazardous substance that was part of a release was disposed of, on, in, or at the facility. To qualify for this protection, the borrower must perform the "all appropriate inquiry" prior to purchase. The availability of this defense hinges on establishing that the purchaser/borrower had no knowledge, and had no reason to know, of the presence of hazardous substances on the site—a difficult burden to meet at many sites that are the subject of transactions. This protection, if applicable, is a complete defense to CERCLA and HSCA.

In response to concerns about the limitations of the "innocent landowner" defense, CERCLA was amended to create a new form of liability protection – the bona fide prospective purchaser protection. This provision affords protection to an owner that did have knowledge of contamination, and limits EPA's recourse for response costs to a lien on the property for the increase in value attributable to EPA's response action. For this protection to apply, all disposal of hazardous substances at the facility must have occurred prior to the borrower acquiring the property, "all appropriate inquiry" must be performed prior to acquisition, and the purchaser/borrower must take appropriate care with respect to hazardous substances found at the property.

Brownfield Development Program

In light of the uncertainty that can exist as to the applicability of these defenses and exemptions, Delaware and many other states have developed "Brownfields" programs to ease the path to re-utilization of contaminated sites. The Delaware Brownfield Development Program was created to spark investment in the large stockpile of former industrial sites across Delaware which had been siting unused, in part due to concern for potential CERLCA/HSCA liability. The Brownfield Development Program provides protection to purchasers of contaminated property even when contamination is present and known to the purchaser prior to closing, provided that the purchaser investigates the contamination and agrees to remediate the site to a level appropriate for its intended use.

Pursuant to the Brownfield Development Program, a brownfield developer will execute a Brownfield Development Agreement with DNREC, and the agreement will set forth a scope and schedule of activities to assess and respond to the release of hazardous substances. HSCA provides that a brownfield developer that enters into a Brownfield Development Agreement is not liable for any release of hazardous substances existing when the agreement is executed, and is not liable for a remedy or any costs incurred by the State or any other person to remedy a release of hazardous substances. The developer must obtain approval for its plan to address the presence of hazardous substances, and must perform any land-disturbing activity at the facility in accordance with that plan. As an additional potential benefit under the program, a developer may be able to obtain DNREC grants for qualifying projects.

The appeal of the Brownfield Development Program is that a developer need not conduct the typical full cleanup required under HSCA, but instead must take appropriate care to stop ongoing releases of hazardous substances, and must also use risk-based corrective action principles to remediate to a level appropriate for the site's planned future use. Careful negotiation of the Brownfield Development Agreement is essential, as that agreement defines the scope and extent of the developer's liability (and indeed its ability to develop the site). In the ideal circumstance, the developer will work together with an experienced environmental consultant, legal counsel, and DNREC staff to formulate a site-specific agreement that allows site development to proceed and affords the developer (and its lender) with appropriate liability protection.

Lender Liability – Secured Creditor Exemption

Lenders should also keep in mind their potential liability as an owner or operator of a site where a release of hazardous substances has taken place, namely when a lender exercises control or management over a borrower's operations. Both CERCLA and HSCA contain "secured creditor" exemptions from liability, as each statute has been amended to provide more certainty to lenders faced with contaminated sites in their loan portfolios. HSCA and CERCLA exempt from liability a person who holds or acquires title to or possession of a property to protect their security interest in that property but does not participate in management of that property.

Key to the lender liability exemption is that the lender must not participate in management of the property. HSCA and CERCLA

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provide the same examples of "participation in management," which include if a lender exercises decision-making control over the facility's environmental compliance, or exercises control at a level comparable to that of a facility manager, among others. Participation in management generally does not include simply holding a security interest (such as a mortgage lien), monitoring or enforcing the security interest (such as foreclosing or accepting a deed-in-lieu), inspecting the facility, or requiring a response action or other lawful means of addressing a release or threatened release in connection with the facility during the extension of credit.

Thus a lender who forecloses on a site is not liable under HSCA absent the lender actually managing the property, but the lender must sell the property after foreclosure, and it must market the property at the earliest practicable and commercially reasonable time, and on commercially reasonable terms. Lenders who work with distressed real estate know that often a property can go into waste and be subject to poor management before the institution of the foreclosure or deed-in-lieu is accepted. This is a tricky place for a lender to be. On one hand it is important to not manage a property to maintain the liability exemption under HSCA; on the other, swift action is frequently needed before the lender can exercise a foreclosure or deed-in-lieu. In such circumstances it is especially important to consult with legal counsel. Frequently loan documents will give the lender the right to seek a receiver in the event of a default. Appointment of a receiver is a technique frequently used by lenders to address concerns about the property management while not actually becoming responsible for the management of the property, thus maintaining liability protection from environmental damages.

When a lender is considering a workout, foreclosure or other actions against a borrower who is in default of its loan obligations, regardless of whether known contamination is present, it is in the lender's best interest to consult with legal counsel. Even if no known contamination exists, a lender may still face liability if contamination is discovered in the future and a release was determined to have taken place while the lender was participating in management of the property.

Environmental Representations, Warranties and Indemnities

What is a lender to do when a borrower is seeking a loan to purchase a property that has known or suspected contamination, in light of the uncertain applicability of the aforementioned prospective purchaser protections? In addition to conducting environmental due diligence, the lender should consider obtaining environmental representations, warranties, and or indemnities from the sponsor or other entity or capable individual. In order for the indemnity to be meaningful, it is important that the indemnitor remain solvent and able to satisfy its obligations under any such indemnities. Further, in the context of a site acquisition, the buyer/borrower may attempt to obtain from the seller of the property indemnities for any known contamination, to the extent a seller will give them. This in turn may facilitate the borrower's ability to provide an environmental indemnity to the bank that is financing the borrower's acquisition of the property. In addition, it is becoming more common to see policies of environmental insurance issued at closing. If an environmental insurance policy is being issued it might be possible for the lender to be named as an additional insured party.

In order to protect themselves from the potential for CERCLA and HSCA liability, lenders should work with a team of environmental and real estate legal counsel and consultants to assess the specific risks and liabilities presented by a particular loan, and to develop a robust internal environmental due diligence program. Regardless of the stage of a transaction, whether in initial discussions with a borrower, loan negotiation, closing, servicing, workout, or foreclosure, a team of environmental and real estate professionals can effectively guide lenders through the various pitfalls that may arise.

Robert W. Whetzel advises a wide range of clients on issues arising under federal and state environmental laws. He has extensive experience with federal and state environmental agencies, and has served on the Delaware Coastal Zone Act Regulatory Advisory Committee, the Delaware Hazardous Substances Cleanup Act Advisory Committee, and other regulatory committees. Mr. Whetzel has also been active on legislative matters in Delaware, and has drafted, commented, and testified on many of the state's key environmental laws. Mr. Whetzel's practice includes permitting, transactional matters, compliance advice, enforcement, and private-party environmental litigation, involving the full spectrum of environmental issues.

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Notes:
1- Currently admitted in Illinois only.
2 - See Environmental Issues in Business Transactions, Chapter 11 Overview of Lender Liability Under Environmental Laws (2011).

3 -“CERCLA” refers to the Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. §§ 9601 to 9675.

4 - “HSCA” refers to the Hazardous Substance Cleanup Act, 7 Delaware Code Chapter 91.

5 - “Release” is defined as “any spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping, or disposing into the environment[.]” The definition encompasses both passive and active activities by a PRP. “Hazardous substance” includes (A) any substance designated pursuant to section 311(b)(2)(A) of the Federal Water Pollution Control Act (also known as the Clean Water Act), (B) any element, compound, mixture, solution, or substance designated pursuant to section 9602 of CERLCA, (C) any substance designated as hazardous waste under the Solid Waste Disposal Act, (D) any toxic pollutant listed under section 307(a) of the Federal Water Pollution Control Act, (E) any hazardous air pollutant listed under section 112 of the Clean Air Act, and (F) any imminently hazardous chemical substance or mixture that the EPA Administrator has taken action with pursuant to section 7 of the Toxic Substances Control Act.

6 - In the context of underground storage tanks, the Solid Waste Disposal Act, Subchapter IX, Regulation of Underground Storage Tanks defines “regulated substance” to include petroleum, 42 U.S.C. § 6991(7)(B), and the Delaware Underground Storage Tank Act (“DUSTA”) also defines “regulated substance” to include petroleum. 7 Del. C. § 7402(18)(b). DUSTA employs a liability scheme similar to CERCLA and HSCA in that under DUSTA a “responsible party” is any person who owns or operates a facility, or caused or contributed to a release from an underground storage tank system.

7 - Another exemption is the contiguous property owner exemption, which excludes from “owner” or “operator” a person who owns property that is contiguous to a facility that is the only source of contamination found on that person’s property. Persons who prior to purchase know or have reason to know that the property could be contaminated cannot qualify for the contiguous property owner protection. Again, the AAI must be conducted for the exemption to apply.