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REAL ESTATE FINANCE

Keeping an Eye on CERCLA While Exercising Remedies



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Several years into a difficult economic climate, as commercial borrowers continue to default on loans secured by real property, a growing number of lenders face the prospect of employing the remedy of foreclosure. While financial institutions that make loans secured by commercial real estate are generally aware of the risks posed by foreclosing on real property that could or does in fact contain a hazardous substance covered by the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, as amended (CERCLA),¹ even sophisticated parties can place undue reliance on the protection of the statute's safe harbor for secured creditors or personal indemnities from borrower principals. While in certain circumstances the safe harbor protects foreclosing lenders from CERCLA liability, the scope of that protection is limited and, in many places, poorly defined. Even recent developments in CERCLA jurisprudence do not reveal a comprehensive or consistent body of law that lenders can rely on with more confidence than caution.

CERCLA, popularly called "Superfund," empowers the U.S. Environmental Protection Agency (the EPA) to compel the remediation of released hazardous substances by current "owners and operators" of the sites of such releases (referred to under the statute as "potentially responsible parties" (PRPs)). CERCLA imposes both strict liability and joint and several liability on PRPs. A lender who is deemed a PRP through its foreclosure on real estate collateral could therefore become fully liable for environmental conditions that the lender did not cause, the cost of which greatly exceeds the value of the bank's investment in the property and may predate by years the date on which the lender acquired the property.

Because of the effect a CERCLA designation may have on the credit available to owners of contaminated properties, from its inception CERCLA has contemplated an exemption for secured creditors. This exemption's tangled history, however, is indicative of the unsettledness that characterizes this area of law.

From enactment, CERCLA exempted from liability a lender that "holds indicia of ownership primarily to protect his security interest."² The legal uncertainty generated by this provision was later exacerbated by the decision in *United States v. Fleet Factors*,³ in which the U.S. Court of Appeals for the Eleventh Circuit held that a lender could become liable as a PRP if its financial oversight provided it with the "capacity to influence" the borrower's environmental procedures. In response to *Fleet Factors*, the EPA issued a so-called Lender Liability Rule⁴ in 1992 to provide specific guidance concerning types of activities lenders could take without triggering CERCLA liability. After lawmakers saw the Lender Liability Rule vacated on administrative grounds in 1994,⁵ the U.S. Department of Justice and the EPA issued a similarly ill-fated joint memorandum that did not have the effect of law or provide comfort with respect to suits brought by private parties.⁶ To address this lack of firm rule, Congress subsequently amended CERCLA by codifying the secured-creditor exemption as part of the U.S. Asset Conservation, Lender Liability and Deposit Insurance Act of 1996.

Under the amended CERCLA rules, lenders can rely on the secured creditor safe harbor by establishing (i) that prior to foreclosure, the lender was (A) a bona fide secured creditor and (B) never participated in the borrower's management and (ii) that subsequent to foreclosure, the lender neither owns nor operates the borrower's property except for the purposes of preserving its value.

To properly establish itself as a protected secured creditor, the lender must hold its security interest in the real property primarily to secure the repayment of money or another obligation of the borrower. Applicable security interests include "a right under a mortgage, deed of trust, assignment,

judgment lien, pledge, security agreement, factoring agreement, or lease and any other right accruing to a person to secure the repayment of money, the performance of a duty, or any other obligation by a nonaffiliated person."⁷ Although this determination is fairly straightforward, lenders should be advised that several courts in the past have gone beyond merely establishing the existence of the indicia to investigating the purposes behind holding them.⁸

Secondly, the lender must establish the extent to which it may exercise prudent oversight over its loan collateral while maintaining sufficient distance from the actual management of the borrower's property.⁹ CERCLA expressly excludes certain actions from qualifying as "participation in management," including (i) conducting property inspections; and (ii) requiring a response to the actual or threatened release of a hazardous substance.¹⁰

However, while collateral oversight actions are largely acceptable and properly isolate a secured lender from environmental liability, CERCLA does provide that a lender will be deemed to have participated in the management of the borrower's property if it: (i) makes decisions or takes responsibility for or control of the property's hazardous substance handling or disposal; or (ii) exercises managerial control over day-to-day decision making with respect to environmental matters or the "operational functions" of the facility other than the functions of environmental compliance.¹¹ Without a bright-line test distinguishing permissible environmental monitoring activities from impermissible ones, lenders must mind their actions carefully to avoid liability.

Participating in Management

Establishing whether a lender participated in management is a fact-sensitive inquiry, for which only limited judicial guidance exists. Mechanical reliance on the statutorily enumerated activities could prove insufficient to insulate a lender from liability. For instance, a lender could incur CERCLA liability if its activities with respect to a property individually fall within the letter of the law but collectively place the lender in de facto

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control of the property's environmental matters. Generally speaking, a lender can expect not to be considered to be "participating in management" if it only acts in furtherance of the preservation of the underlying collateral in a manner consistent with market practice.

The lender must establish grounds for pre-foreclosure reliance on the secured creditor safe harbor as a necessary precondition for relying on it post-foreclosure. After seizing the property, the lender can preserve the safe harbor only by selling the foreclosed property promptly while not acting in a way that would cause it to be deemed a PRP. As a result, both the period of time in which the lender must sell the property and operation of that property in the interim can provide a basis for challenging a lender's post-foreclosure reliance on the safe harbor.

After foreclosure, the lender must make commercially reasonable efforts to divest itself of the property at the earliest commercially reasonable time on commercially reasonable terms, taking into account market, legal and regulatory considerations.¹² CERCLA does not indicate what length of time is considered commercially reasonable. The EPA has provided separate guidance that listing the property with a broker or advertising it for sale within 12 months of the foreclosure is generally acceptable, but has considered, and declined, to provide a bright-line rule for holding the property. As determining whether a holding period is commercially reasonable is clearly a fact-sensitive inquiry, lenders should thoroughly document their marketing efforts during the period. The lender should also be aware that at some point the tenure of possession could extend long enough for the lender to be deemed the property's owner or operator.

As discussed, the safe harbor provision permits the lender to operate the property while attempting to sell, re-lease, or otherwise dispose of property. This operation can take the form of maintaining or winding up any business activities on the property, addressing the actual or threatened release of the hazardous material, or otherwise taking steps to preserve the property's value. If the lender begins to act as a property owner (e.g., by expanding any business on the property or soliciting investors), however, it runs the risk of being deemed the property's owner or operator. This is another fact-and-circumstance inquiry that does not admit to a ready rule. The lender must therefore similarly document that all actions with respect to the property were taken merely to maintain the property's value. With today's lenders frequently taking over existing unsold condominium units, foreclosing mortgagees ought to carefully monitor their sales efforts to demonstrate active marketing.

Even if the lender successfully navigates the challenges of staying within the CERCLA secured creditor safe harbor, the limits of that exemption could pose further complications.

First, the safe harbor only insulates the lender from liability as a PRP under CERCLA. To the extent that an environmental liability is not governed by CERCLA (such as, for example, petroleum or natural gas, which are not defined as a "hazardous substances" under the statute), or liability is incurred under another federal or

applicable state statute, the lender is not protected by CERCLA's safe harbor.

Second, the safe harbor provisions only protect the lender when it forecloses on the borrower's real property directly rather than foreclosing on the borrower's equity. Any mezzanine lender foreclosing on the membership interests of a borrower owning CERCLA-designated property would end up the borrower's parent or corporate successor, and thereby assume the property's CERCLA liability.

Third, the secured creditor exemption only offers lenders protection from liability for past contamination based upon their status as lenders or as owners after foreclosure; a lender's actions or omissions that cause new contamination can independently serve as a basis for deeming a lender an "operator" (and hence a PRP) of the property.¹³

This responsibility for contamination can be imputed to a lender for actions that are relatively remote to the environmental liability. In one much-discussed case, *New York v. HSBC USA, N.A.*,¹⁴ the State of New York claimed a lender was outside of the secured creditor exemption because it had instituted a lock-box on all of a borrower's operating funds, and denied disbursements necessary for the borrower to comply with environmental regulations.

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The lender settled out of court for nearly \$1 million in civil penalties and costs. Although the settlement precluded the creation of judicial precedent, the case demonstrates that lenders can be pursued for CERCLA damages for actions that could be seen as protective of the loan and not "participation in management." Any significant control over the company's environmental management, even through commonly used financing conventions such as cash management, could conceivably lead to a lender's liability for any resulting contamination or noncompliance.

Finally, as a practical concern, even if the lender can comfortably rely on the safe harbor from CERCLA liability, that protection will not be available to any prospective third party purchaser of the foreclosed property. This could have the effect of reducing the value of the collateral by the amount necessary to remediate any contamination. The lender is also at a disadvantage in negotiating sales with prospective purchasers, as holding on to the property for too long can cause the lender to be deemed the property's owner and operator.

Remedies

In light of these concerns, a lender considering foreclosure should carefully review all reasonable alternatives. This does not mean, however, that the lender has no options in the face of a borrower with contaminated collateral.

The lender could foreclose on the property in reliance upon the environmental indemnities that are standard in most sophisticated loan agreements. Under typical environmental indemnification clauses, the borrower, its affiliates and its principals are liable for any costs incurred to clean up any contamination of the collateral. These clauses typically survive the loan's repayment or default, and can, if skillfully drafted, protect the lender even after the property's sale to a third party. Even if a lender does not intend to foreclose, a strong indemnification provision from a creditworthy individual or entity can serve as an insurance policy should an attempt be later made to characterize the lender as a PRP.

Alternatively, when appropriate, a lender can seek to have the property administered by a court-appointed receiver or other suitable fiduciary. Naturally the availability of these alternatives turns on underlying circumstances and applicable law; however, there are no grounds for assuming that either the borrower or the lender must always hold the real property.

In conclusion, a lender contemplating foreclosure on CERCLA-implicated property cannot assume that its status as a secured creditor automatically entitles it to the secured creditor safe harbor. A lender must have established its appropriate conduct with respect to the property's management before foreclosure and should have a plan for disposing of the property afterwards. An observance of the niceties of the law in these circumstances is particularly important to lenders, as federal and state environmental agencies attempting to fund remediation and PRPs seeking contributors are all incentivized to prove lender noncompliance. With caution and an acknowledgment of both the legal and practical aspects of the safe harbor, however, a lender can chart a course of action with as much confidence as this area of law permits.

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- 42 U.S.C. §§9601 et seq.
 - 42 U.S.C. §9601(20)(A)(iii).
 - 901 F.2d 1550 (11th Cir. 1990), cert. denied, 498 U.S. 1046 (1991).
 - 57 Fed. Reg. 18344 (1992).
 - Kelley v. EPA*, 15 F.3d 1100 (D.C. Cir. 1994).
 - Office of Enforcement and Compliance Assurance, Environmental Protection Agency, and Environment and Natural Resources Division, Department of Justice, Policy on CERCLA Enforcement Against Lenders and Government Entities that Acquire Property Involuntarily (Oct. 23, 1995).
 - 42 U.S.C. §9601(20)(G)(vi).
 - See, e.g., *Monarch Tile Inc. v. City of Florence*, 212 F.3d 1219 (11th Cir. 2000).
 - 42 U.S.C. §9601(20)(F).
 - 42 U.S.C. §9601(20)(F)(iv).
 - 42 U.S.C. §9601(20)(F)-(G).
 - 42 U.S.C. §9601(20)(E)(ii).
 - See, e.g., *F.P. Woll Co. v. Fifth & Mitchell St. Corp.*, 1997 WL 535936, unreported (E.D. Pa. 1997).
 - Docket No. 07-CV-3160 (Dec. 22, 2006 Consent Decree).

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