Managing Environmental Risk: Real Property Used as Collateral

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INTRODUCTION

> **“The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws have become important factors in evaluating real estate transactions and making loans secured by real estate.”**

The FDIC’s *Guidelines for an Environmental Risk Program* [Source: FDIC Financial Institution Letter (FIL—14—93), dated Feb. 25, 1993], *available at* www.fdic.gov/regulations/laws/rules/5000-4900.html

RISK

- >Government recovery lien superior to other liens
- >Borrower's capacity to pay
- >Real Estate Collateral Value/Marketing
- >Direct liability

DIRECT LIABILITY RISK

> **Federal law**

> **State law**

> **Other**

  – Common law tort actions (nuisance, trespass, other)

> **Foreclosure = risks significantly increase!**

  – In a distressed context, a lender must be particularly careful, particularly with respect to any level of management of the property; otherwise lender liability could become direct environmental liability

FEDERAL SOURCES OF DIRECT LIABILITY RISK

- >CERCLA
- >RCRA, CWA, CAA, TSCA
- >Other

FEDERAL SOURCES OF DIRECT LIABILITY RISK: CERCLA

> **CERCLA imposes strict and joint liability on four classes of potentially responsible parties ("PRPs") for the cleanup and reimbursement of costs associated with releases of hazardous substances. The four classes of PRPs include past and current owners of facilities and vessels (i.e., tanks, equipment, etc.), past and current operators of facilities and vessels, generators of hazardous substances, and transporters of hazardous substances.**

42 U.S.C. §§ 9601-9675.

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FEDERAL SOURCES OF DIRECT LIABILITY RISK:RCRA

- RCRA regulates the generation, storage, handling, transportation and disposal of hazardous waste. Owners or operators of RCRA-regulated facilities must comply with certain operating standards and are also required to undertake corrective action to cleanup contamination caused by hazardous or solid wastes.
- Lenders foreclosing on property are especially at risk where any unsold inventory of hazardous substances remain on a site.

42 U.S.C. §§ 6901-6992k.

FEDERAL SOURCES OF DIRECT LIABILITY RISK: CWA

- More foreclosures in recent years has prompted regulators to look beyond CERCLA and RCRA when targeting lenders for environmental liabilities.
- The Clean Water Act ("CWA ")poses a particular concern for lenders foreclosing on unfinished construction sites, where there may be substantial stormwater runoff due to the developer's failure to complete its public works obligations.

33 U.S.C. §§ 1251-1387.

FEDERAL SOURCES OF DIRECT LIABILITY RISK: CAA

- **Similarly, airborne dust from construction sites could implicate provisions of the Clean Air Act (“CAA ”) to the extent that such condition must be permitted or controlled.**

42 U.S.C. §§ 7401-7671q.

STATE SOURCES OF DIRECT LIABILITY RISK: VWMA

> **Virginia Waste Management Act**
  - solid waste and hazardous waste, transport of hazardous materials, voluntary remediation, regulated medical waste, waste tires, coal combustion by-products and yard waste composting.

Va. Code §§ 10.1-1400 through 1458.

STATE SOURCES OF DIRECT LIABILITY RISK: SWCL

> **State Water Control Law**
  - aboveground storage tanks
  - underground storage tanks

Va. Code §§ 62.1-44.2 through 44.34:28.

> **(Virginia's Voluntary Remediation Program)**

Va. Code § 10.1-1232.

THIRD PARTY CLAIMS

- **Health and safety issues**
- **Off-site migration of contamination**
- **Vapor intrusion**
- **Receptors (groundwater wells, sensitive environments)**
- **Institutional/use controls**
- **MAY LEAD TO TORT CLAIMS**
  - Nuisance and trespass most common

RISK PROTECTION

- >Federal
- >State
- >Private contract/indemnification
- >Insurance
- >Environmental Risk Management Program

FEDERAL PROTECTIONS
CERCLA Secured Creditor Exemption

- Section 101(20)(A) of CERCLA excludes from the definition of an "owner or operator" any "person, who, without participating in the management of a . . . facility, holds indicia of ownership primarily to protect his security interest in the . . . facility."

FEDERAL PROTECTIONS
CERCLA Secured Creditor Exemption

> **After foreclosure, a lender who did not "participate in management" prior to foreclosure may generally:**

- maintain business activities;
- wind up operations;
- undertake a response action under CERCLA Section 107(d)(1) or under the direction of an on-scene coordinator;
- sell, re-lease or liquidate the facility; or
- take actions to preserve, protect or prepare the property for sale.

42 U.S.C. § 9601(20)(E)(ii).

FEDERAL PROTECTIONS
CERCLA All Appropriate Inquiry

> **The EPA's All Appropriate Inquiries Rule governing the scope of Phase I Environmental Site Assessments went into effect on November 1, 2006 and provided specific scope requirements for a Phase I ESA to meet the requirements of CERCLA's innocent land owner defense.**

  – Important for purchasers/marketability
  – Additional protection for lenders
  – Current standard ASTM 1527-05

FEDERAL PROTECTIONS
CERCLA All Appropriate Inquiry

> **NEW Proposed ASTM E1527-13**

- New definition of Recognized Environmental Condition (RECs).
- New emphasis on Vapor Intrusion risks.
- Increase in review and reporting requirements for Environmental Professionals.

FEDERAL PROTECTIONS
RCRA Secured Creditor Exemption

- **The RCRA secured creditor's exemption provides that a lender who has indicia of ownership in a UST system (i.e., one or more USTs) or property containing a UST system will not be liable as an owner or operator of the UST system if: (i) the indicia of ownership is held primarily to protect a security interest; (ii) the lender does not participate in the management of the UST system, and; (iii) the lender is not engaged in petroleum production, refining or marketing.**

42 U.S.C. 6991(b)(h)(9).

FEDERAL PROTECTIONS
CWA and CAA

- **No statue-specific secured creditor exemptions/protections**

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STATE PROTECTIONS: Brownfields Restoration and Land Renewal Act

>Va. Code § 10.1-1234. Limitations on liability.

The Director may, consistent with programs developed under the federal acts, make a determination to limit the liability of lenders, innocent purchasers or landowners, de minimis contributors or others who have grounds to claim limited responsibility for a containment or cleanup that may be required pursuant to the Virginia Waste Management Act (§ 10.1-1400 et seq.), the State Water Control Law (§ 62.1-44.2 et seq.), the State Air Pollution Control Law (§ 10.1-1300 et seq.), or any other applicable law.

STATE PROTECTIONS: Virginia's Lender Liability Exemption (USTs)

- **Effective July 1, 1996, State Water Control Law allows certain persons or entities ("holders") to foreclose on properties on which petroleum underground storage tanks (USTs) are located without assuming owner/operator liability.**
- **Holders also may conduct cleanup of leaking USTs on foreclosed properties and qualify for reimbursement from the Virginia Petroleum Storage Tank Fund without assuming owner/operator liability for a petroleum release.**
- **DEQ Guidance Memo No. 05-2016**

STATE PROTECTIONS: Virginia's Lender Liability Exemption (USTs)

Broadly described, exemption is available:

- to a holder
- from the time that the holder extends the credit up through and including foreclosure and re-sale
- for certain USTs

STATE PROTECTIONS: Virginia's Lender Liability Exemption (USTs)

Provided that the holder DOES NOT:

- participate in the management of the UST
- operate the UST (either someone else is the operator, or the UST is not in operation)
- engage in petroleum production, refining, and marketing

Provided that the holder DOES:

- act expeditiously to divest itself of the USTs or the property where the USTs exist.

STATE PROTECTIONS: Virginia's Lender Liability Exemption (USTs)

- **To take advantage of the liability exemption, a holder must first notify DEQ using the Lender Liability Exemption Application form and obtain DEQ's written approval of the liability exemption**

PRIVATE CONTRACT LIABILITY PROTECTIONS

- **Explicit risk and responsibility allocation by contract**
- **Contractual indemnification**
- **Important, but not always enough!**

INSURANCE PROTECTION

> **Examples:**

> **“Pollution Legal Liability” (“PLL”) Policies**

- run to the benefit of the property owner
- cover legally required investigation, defense, and remediation costs associated with previously unknown historic and/or future contamination

> **“Lender” Environmental Liability Policies**

- Coverage usually triggered by an event of borrower default and an accompanying discovery of a Pollution Condition
- Portfolio vs. one-off transaction approaches
- Usually designed to help avoid foreclosure by paying off loan balance

ENVIRONMENTAL RISK MANAGEMENT PROGRAM PROTECTION

- **Financial institutions should have in place a program that establishes and implements procedures for identifying and evaluating potential environmental concerns associated with the use of real property as collateral**

ERM PROGRAM COMPONENTS

- Development and regular updating of loan policies, manuals and written procedures addressing environmental issues (institution-specific)
  - Foreclosure situations should involve separate procedures

- Training
  - If and when complexity requires, hire outside counsel/consultants

ERM PROGRAM COMPONENTS

- Routine Environmental Risk Analysis (Triage!)
- Environmental risk monitoring throughout life of loan (but no participation in management!)
- Loan documentation (language is important)

CONCLUSION

> **The keys to managing environmental risk associated with real property used as collateral:**

- – Understand the nature and extent of contamination/risks at the site
- – Clearly identify and quantify the risks
- – Minimize the risks by utilizing as may protections as may be available
- – Have a plan in place to manage liabilities should they materialize

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QUESTIONS?

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