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Environmentally Challenged Property Foreclosures In A Crisis

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Environmentally challenged properties were front and center of many troubled transactions in the last major economic downturn. Secured creditors learned that, after foreclosing on partially completed subdivisions, struggling brownfield mixed-use developments and renewable energy projects, they were not exempt — post-closure — from becoming the owner or operator of these projects under environmental law.

With a long-expected recession now more likely, and with the economic implications of COVID-19 continuing to evolve, here's several lessons learned for lenders considering foreclosure on properties or businesses with environmental challenges.

Secured creditor and lender protections are available under many, but not all environmental statutes.

For any lender considering foreclosure, many environmental laws — both federal and state — include secured creditor or lender exemptions. The Comprehensive Environmental Response, Compensation and Liability Act, or CERCLA, the most important environmental law in real estate and corporate transactions covering contaminated sites, and the Resource Conservation and Recovery Act, or RCRA, the federal law governing solid and hazardous waste management, both have secured creditor exemptions. Other state environmental laws also include secured creditor exemptions or defenses.

Under these secured creditor exemptions, a lender will not be considered an owner or operator of a property, provided the lender complies with a host of preforeclosure requirements. As a result, a lender may still hold environmentally challenged security without being subject to certain environmental liabilities.

Under these statutes, lenders are broadly defined, including any person that makes a bona fide extension of credit or acquires a security interest from a nonaffiliated party, any person who insures or guarantees against a default in the repayment of an extension of credit, or any person who acts as a surety in such circumstances.

Yet most other federal and state environmental statutes do not include secured creditor exemptions. Neither the Clean Water Act nor the Clean Air Act, for example, includes a secured creditor exemption. And many state environmental statutes, covering a wide range of media and issues from groundwater withdrawals to medical waste management, include no secured creditor exemptions.

Without an exemption, a lender who acquires the property in the foreclosure sale may become an owner or operator of a facility. To use an example from the 2007 downturn, if a bank holds a security interest in 50 lots in a 200-acre residential development, but forecloses on the development while some lots are under construction, the bank may be solely liable for complying with Clean Water Act provisions related to soil and erosion control, silt fences, wetlands permitting, and land disturbance permit compliance.

Similarly, if a secured creditor forecloses on a half-built, or built but not yet operating, waste-to-energy plant, a holder may be required to operate air pollution control technologies or complete construction within the time periods required by air quality permit since the Clean Air Act includes no secured creditor exemption. Practically, the lack of secured creditor exemptions under these statutes means holders may need to negotiate with federal and state agencies on how to handle those specific responsibilities before they foreclose.

Nor do the secured creditor exemptions provide defenses to liability for environmental tort lawsuits such as trespass and nuisance. Accordingly, as a new owner of environmentally challenged property through foreclosure, a lender confronts an arcane set of potential environmental liabilities.

Specific environmental secured creditor protections differ statute by statute.

The technical limitations of the secured creditor exemptions under CERCLA, RCRA and many state statutes are not intuitive. The RCRA secured creditor exemption covers only properties with underground storage tanks and UST systems containing petroleum hydrocarbons, not USTs containing hazardous wastes or medical or pharmaceutical wastes, and not covering solid waste or hazardous waste landfills or other types of facilities and wastes regulated by RCRA.

At the same time, the CERCLA secured creditor exemption potentially covers a wide range of contaminated sites impacted by a range of hazardous substances, including brownfield sites with old dry cleaners and currently operating industrial facilities.

Before they can rely on the exemptions under CERCLA and RCRA, secured creditors must meet certain preconditions. As the U.S. Environmental Protection Agency explains, a secured creditor who participates in management of the borrower cannot receive the protections of the CERCLA exemption. Participating in management of the borrower, means:

- Exercising decision-making control over environmental compliance at a facility to an extent that it would be responsible for hazardous substance handling or disposal practices; or

- Exercising control as a de facto manager of the facility with responsibility for day-to-day decision making on environmental compliance or all, or substantially all, of the operational functions of the facility other than environmental compliance.

Under RCRA, "participation in management" means actual participation by the holder in the management or control of decision making related to the operation of an UST or UST system. In other words, when a lender becomes or acts like a business partner with the borrower instead of being a secured lender, the CERCLA and RCRA secured creditor exemptions will not apply.

In its regulations, the EPA provides considerable day-to-day leeway for secured creditors. Secured creditors can, for example, under EPA regulations and without voiding the exemption:

- Hold, abandon or release a security interest;
- Monitor or enforce terms and conditions of credit;
- Monitor or inspect a borrower's facility;
- Require that a borrower take action to address a release or threatened release of a hazardous substance;
- Provide financial or other advice to the borrower to mitigate, prevent or cure default or diminution in the value of the facility;
- Include covenants, warranties or other terms or conditions relating to environmental compliance; and
- Restructure the terms, extend credit, or exercise a forbearance.

In certain situations, a lender can conduct a response action under CERCLA or under the National Contingency Plan, provided that these actions do not rise to the level of participation in management within the meaning of the statute. In short, most the actions a holder needs to take to protect its security likely will fall under this defined list of permitted activities.

Take advantage of environmental inspection rights in loan agreements and collect other environmental compliance information on the security preforeclosure.

Because the statutory secured creditor exemptions only cover certain liabilities, having up-to-date environmental information is critical to the ultimate foreclosure decision when it involves environmentally challenged properties. Before foreclosing on real property, a secured lender should — if it did not during the credit risk assessment — assemble and analyze all environmental reports, testing data and environmental compliance information.

As soon as possible, lenders should exercise their rights under the loan agreement or credit facility to force the borrower, if it still has the resources, to conduct an assessment of current environmental conditions and operating compliance at the property.

If the borrower refuses or has no resources to inspect the security, the lender should conduct the assessment. Depending on the type of business, it is prudent to conduct limited soil, groundwater, or air testing preforeclosure. At a minimum, however, a lender should — preforeclosure — conduct a desktop review that includes a detailed review of publicly available environmental records to determine if any actual or alleged violations or non-compliance at the properties exist.

As part of this preforeclosure due diligence, secured creditors should determine if the borrower took advantage of a brownfield or a voluntary cleanup program, which typically give purchasers or owners legal protections if they implemented certain environmental actions, such as restrictive covenants or other environmental actions. If so, those programs may give secured creditors the same liability protections post-foreclosure.

The protections, if available, will differ state by state. Finally, lenders should inquire whether a borrow has environmental insurance which may — or may not — have been part of the lending decision, which may benefit lenders. Only with all environmental data and information in hand can a lender develop the most effective environmental strategy prior to foreclosing.

Recognize certain environmental actions are required and others are prohibited post-foreclosure.

Even if a secured creditor complies with all preforeclosure requirements, the actions that a lender can take post-foreclosure are still limited. In short, a lender cannot operate carte blanche post-foreclosure without risking the lender protections under certain federal statutes.

Post-foreclosure, a lender may under CERCLA: maintain business activities; wind up operations; undertake a response effort (i.e., a defined type of remediation); sell, re-lease or liquidate a property; or take actions to preserve, protect or prepare a property for sale.

A lender holding security in USTs or UST systems on properties has far less flexibility. After foreclosing on property with a UST or UST system under RCRA, a holder cannot continue to use, store, dispense, or fill petroleum in the UST or UST system after obtaining marketable title and access to the UST.

Following a bright-line test, a holder can ensure compliance with the exemption if it empties the USTs within 60 days of taking title. But if a holder forecloses on property containing a UST, but a non-borrower tenant operates the UST, that activity can occur going forward.

In a revelation to many, both CERCLA and RCRA require a secured creditor to take actions post-foreclosure to sell the property with known environmental challenges in relatively short order. Under CERCLA, a holder foreclosing on property must divest its interest "at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."

Under its bright-line test, a holder must, within 12 months following foreclosure, list the property with a broker, dealer, or agent who deals with the type of property in question, or advertise the property in question for sale or disposition. And then if at any time after six months following acquisition of marketable title the holder rejects or does not act upon within 90 days of receipt of a written bona fide offer of fair consideration for the property, the exemption becomes void.

RCRA's secured creditor exemption imposes a similar requirement. But under RCRA, if a holder is unable to dispose of an UST property within 12 months and the tanks are temporarily closed, the holder must conduct a site assessment to determine if the USTs do not meet the UST standards.

In considering offers for the property, fair consideration is generally defined under both statutes as the value equal to or greater than the outstanding obligation owned to the holder (including the fees, penalties, and other charges incurred by the holder in connection with the property), including the amount owned to other creditors with interests in the property.

So while lenders are not required to accept the first fire-sale price for the security, they will need to take steps to market the property in compliance with the exemption.

Conclusions

Foreclosing on environmentally challenged properties is a challenge in itself. Those secured creditors who take actions to protect a security interest but who do not participate in a borrower's management, will stay safely within the exemption. But those who do not may end up as the owner and operator of a new environmental liability.

As the last downturn taught lenders, the more a secured creditor looks like a business partner with a borrower, the less likely it will be able to rely on secured creditor exemptions under environmental statutes.

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