Environmental Lender Liability: Tips to Stay Safe this Summer and Beyond

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Do you remember 1988? It was the year that the *Soviet Union* withdrew from Afghanistan. The Dow Jones Average ended over 2100 points. Residential mortgages averaged around 10.5%. Popular children's toys included Playskool Kitchens and Transformers. And about that year, the term "Environmental Lender Liability" entered banking vocabulary, along with "Phase 1 ESA reports" and "environmental indemnities." For those who have not tracked this subject regularly in the past 25 years, there are plenty of tips that can help lenders "stay safe," especially when they workout or take-back potentially contaminated properties.

The short history lesson begins with the late 1970s discovery that post-WWII industrial chemical production, use and disposal left expensive legacies such as Love Canal. In a lame duck session, Congress passed, and Jimmy Carter signed in early 1981, the so-called "Superfund" law. Known formally as the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), the law created new cleanup liability for hazardous substances and related response costs and imposed it on the *current* owner and operator, the *former* owner or operator at the time of chemical release, those who arranged for chemical disposal, and those who selected and transported chemicals to the disposal site. Within a few years, real estate lenders, fiduciaries and others who took title via foreclosure, gift or other "benign" transfer, found themselves jointly and severally liable for cleanup costs. Lenders and their associations objected.

After a 1992 USEPA regulation providing "secured lender protection" was tossed by a federal court, Congress responded in 1996 with amendments to CERCLA that, among other things, created the so-called "lender liability exemption." Specifically, the definition of "owner or operator" was revised to *exclude* any "person who, without participating in the management of a . . . facility, holds indicia of ownership *primarily to protect his security interest* in the . . . facility." **Thus, mere holding of a mortgage does not create liability.** However,

taking fee simple ownership, or in some instances taking control, of a contaminated property may create liability.

Fortunately, the 1996 amendments created some special safety protections for lenders considering – or taking title to property in workout, foreclosure, deed in lieu or other REO situations. The balance of this article explains how to "stay safe" and utilize those protections under federal law. It is worth noting that Ohio and some other states have similar, state law protections, some including for former gasoline stations, whose petroleum-related contamination is generally exempt from CERCLA.

There are two key elements to the "stay safe" protection created in 1996.

First, the entity must qualify as a "lender," which is defined broadly. Second, the lender must not "*participate in management*" of the facility. "Participate in management" is defined to mean "actually participating in the management or affairs of a . . . facility [and] does not include merely having the capacity to influence" facility operations. A lender "participates in management" if it exercises decision-making control regarding environmental compliance at the facility and, in doing so, undertakes responsibility for hazardous substance handling or disposal practices.

In the workout stage, a lender is specifically permitted to take title to the real estate to protect its collateral, including, but not limited to:

- financial advising to the borrower to address loan defaults;
- enforcing the terms and conditions of the security interest;
- monitoring or inspecting the facility; and
- requiring a response action in connection with a release or threatened release of a hazardous substance.

Thus, a lender's routine involvement in a secured lender/borrower relationship, which the lender must undertake to protect its interests during workout, is generally protected.

In foreclosure, CERCLA creates a specific exemption. "Foreclosure" is defined to include *acquisition* via judicial or non-judicial sales, deed in lieu transfers and repossession, assuming all arise from the lender's security interest. The lender thus may take title to the borrower property. However, the lender must not have "participated in management" of the property prior to taking title and must continue to avoid "participation in management" during the period prior to the lender's sale/transfer of the site. In any event, the lender-turned-owner of the property must make commercially reasonable efforts to sell, lease or liquidate the property.

To make use of these protections, there are some basic "safety tips" which prudent lenders may wish to follow:

Before taking title:

To help decide whether or not to take title and how to proceed during workout and into ownership of the property, consider:

- Conducting internal environmental screening to identify potential environmental liability at the property. We have developed questionnaires for types of properties.
- Conducting a property inspection to identify any obvious environmental issues.
- Conducting a Phase I Environmental Site Assessment via a qualified consultant, often with the advice of legal counsel.

During ownership:

- Keep a file proving safe harbor requirements compliance.
- Inspect the property regularly.
- Work regularly to sell or lease the property, using advertising and brokers if common.

After divestiture of property:

- Prepare a file providing compliance with the CERCLA safe harbor provisions.

Vorys environmental attorneys have more than three decades experience advising lenders how to protect themselves from environmental liability at the state and federal level. Please contact us if you have questions.