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Lenders Beware: Environmental Conditions at Distressed Property Pose Risks for Foreclosing Lenders

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In this article, the authors identify some of the environmental liability traps that lenders can face when foreclosing on real property.

Foreclosing lenders can be assessed liability for environmental conditions on distressed property under a variety of federal, state, common, and municipal laws. Environmental lender liability is most frequently discussed in the context of the federal Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA").[1] Liability may also be imposed under other environmental laws, many of which lack CERCLA's more lender-friendly provisions.[2] With foreclosure rates at record highs across the country, lenders must be especially vigilant to identify potential liabilities and, where appropriate, take action to ensure that those liabilities are avoided. In addition to CERCLA, this article identifies some of the other environmental liability traps that lenders can face when foreclosing on real property.

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CERCLA

CERCLA has garnered substantial attention from lenders primarily because it imposes both strict[3] and joint and several[4] liability for costs associated with the release and cleanup of hazardous substances. Ordinarily, "potentially responsible parties" ("PRPs") are liable for costs incurred by the government for remediating releases of hazardous substances.[5] PRPs may also be liable to third parties seeking recovery of private response costs or contribution for payments made to the government in excess of the third parties' own fair share.[6] Lenders who take title to property impacted by hazardous substances have good reason to be concerned about CERCLA's strict liability imposed on "owners and operators" of contaminated property.

Whether a foreclosing lender has acted in a manner sufficient to meet the statutory lender liability exemption under CERCLA rarely has a clear answer. In general, under the current rules, a lender who "holds indicia of ownership primarily to protect [its] security interest in the … facility," and who has not "participat[ed] in the management of" that facility, will not be subject to CERCLA liability.[7] Once the lender takes ownership of distressed real estate, the exemption usually protects lenders who not only avoid participation in management of the property, but also act quickly to divest the impacted property.[8] Lenders may also seek protection under the "innocent landowner" defense by making "all appropriate inquiries" into the condition of the property before foreclosing.[9] Whether a lender has satisfied these conditions (which is inherently a subjective determination) is determined by a court. Thus, despite the availability of the lender exemption, a lender would be wise to proceed cautiously and to conduct extensive and documented due diligence before initiating a foreclosure proceeding. This will usually require retention of an environmental consultant to conduct a "paper" investigation into the historical uses and reported events at or near the property, typically referred to as a Phase I investigation. If the Phase I report discloses any potential circumstances or incidents of concern (such as a dry cleaning operations on the property), a Phase II "physical" investigation involving the testing of soil and perhaps groundwater and/or surface water may be warranted.

RESOURCE CONSERVATION AND RECOVERY ACT

Lenders may also face liability under the federal Resource Conservation and Recovery Act ("RCRA")[10] for hazardous waste on distressed property. Federal or state governments may, under RCRA, issue corrective action orders to the owner of a facility that treats, stores, or disposes of hazardous waste, and the government and third parties may sue to compel abatement and remedial action if the waste poses a risk to public health or the environment.[11]

In contrast to CERCLA, RCRA's lender liability exemption is significantly more limited in scope. First, RCRA's lender exemption applies only to protect against liability arising from the ownership or operation of underground storage tanks ("USTs"). Thus, lenders are not protected from liability as foreclosing owners or operators of a RCRA treatment, storage, or disposal facility ("TSDF").[12] In addition, a lender may rely on RCRA's UST exception only if it holds "indicia of ownership" primarily to protect its security interest, it does not participate in the management of the UST system, and it is not engaged in petroleum production, refining, or marketing. Further, RCRA's exemption does not shield lenders from citizen suits.[13] Lenders must, therefore, be especially wary of the limited scope of the lender exemption under RCRA when contemplating foreclosure on a RCRA facility or on property at which operations were subject to regulation under RCRA or a comparable state statute.

CLEAN WATER ACT AND CLEAN AIR ACT

The recent foreclosure spike has prompted regulators to look beyond CERCLA and RCRA when targeting lenders for environmental liabilities.[14] The Clean Water Act ("CWA")[15] poses a particular concern for lenders foreclosing on unfinished construction sites, where the likelihood of substantial stormwater runoff may be significant due to the developer's failure to complete its public works obligations. Unlike CERCLA and RCRA, the CWA lacks a lender exemption, and a foreclosing lender may be caught off-guard by the consequences of suddenly becoming the "owner" of property subject to regulation under the CWA. In one case, a bank is

reported to have been fined in excess of $4 million for failing to construct adequate erosion control facilities on a foreclosed site valued at less than half that amount.[16] Similarly, airborne dust from construction sites could implicate provisions of the Clean Air Act ("CAA")[17] to the extent that such condition must be permitted or controlled. Under either statute, a lender who has repossessed property may be required to bring preexisting conditions into compliance with regulations, pay penalties for noncompliance, or acquire permits. In addition, foreclosing lenders may be the target of citizen suits under both the CWA[18] and the CAA.[19] Careful planning in anticipation of foreclosure can help to minimize such potential liability and significant costs.

STATE AND LOCAL LAWS, REGULATIONS, AND ORDINANCES

In addition to liability arising under federal statutes, lenders may also face liability under state and local environmental laws and regulations after foreclosing on an affected property. California's Hazardous Substances Account Act ("HSAA"),[20] for instance, imposes liability under a structure similar to CERCLA. Like CERCLA, the HSAA also includes a lender liability exemption.[21] Though similar, the CERCLA and HSAA exemptions are not identical. Notably, the HSAA exemption explicitly does not protect the lender if it "outbids, rejects, or fails to act on an offer of fair consideration for the property acquired through foreclosure or its equivalent…."[22] CERCLA, on the other hand, only requires that the lender act to divest the property at the "earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."[23] Many of the so-called "Mini-Superfund Laws" of other states contain provisions different from the CERCLA blueprint.[24] These nuances warrant close examination as they could significantly affect a lender's liability.

Recent activity by state legislatures and agencies may also impact a lender's liability. A California law passed in 2008 authorizes a fine of up to $1,000 per day if a vacant residential property acquired through foreclosure is not properly maintained.[25] Also in California, the Department of Toxic Substances Control issued guidelines in 2008 addressing the respon-

sibilities of a lender to properly dispose of hazardous material abandoned in a foreclosed home.[26] Georgia's Department of Natural Resources, Environmental Protection Division recently issued new stormwater permit regulations that specifically require a lender or other secured creditor who acquires title to a construction site to file a new Notice of Intent soon after acquiring title.[27] By doing so, the lender or other secured creditor will be authorized to discharge stormwater from construction sites under Georgia's NPDES General Permit No. GAR100001.

Municipalities are also taking action against foreclosing lenders to ensure that the cleanup costs for environmental conditions are not assumed by local taxpayers. For instance, an ordinance recently passed by Cathedral City in California requires that owners of foreclosed properties register the property with the city, pay an annual registration fee, maintain the property, and inspect it every week to ensure that the property remains in compliance with all applicable laws and regulations.[28]

COMMON LAW TORT CLAIMS

In addition to the statutes, regulations, and ordinances described above, lenders should also be on the alert for the possibility of tort lawsuits. For example, the Maryland Court of Special Appeals reversed a judgment in favor of a bank in a toxic tort case involving groundwater contamination.[29] Plaintiffs in that case owned property adjacent to and downgradient from a gasoline service station on which the bank had recently foreclosed. The bank arranged to remove underground storage tanks from the property which was later found to be impacted by petroleum byproducts. Plaintiffs asserted claims for negligence, nuisance, trespass, and strict liability against the bank. The appellate court reversed the lower court's dismissal of the bank, rejecting the lower court's ruling that the limited Maryland statutory exemption[30] abrogates Maryland's common law causes of action for negligence, nuisance, trespass, and strict liability against a lender.[31]

Similarly, a federal court in Pennsylvania denied a bank's motion to dismiss a plaintiff's common law claims of public nuisance, negligence, and strict liability for abnormally dangerous or ultrahazardous activity.[32] The bank had foreclosed on and then promptly sold property which had

been contaminated by a mortgagor in default. In its motion, the bank argued (among other things) that the plaintiff's state law claims were barred under Pennsylvania's lender liability law. However, the court declined to make a finding that the bank was only engaged in the routine practices of commercial lending. Instead, at the motion to dismiss stage, the court had to accept as true the plaintiff's allegation that the bank "operated" a facility from which hazardous substances were released. Also, the court could not say that the plaintiff would be unable to establish that the bank owed some duty to plaintiff and that it also breached that duty.[33]

RECOMMENDATIONS

A lender should be aware of the potential environmental conditions and liabilities that may exist at, near, or in connection with distressed real estate and thus conduct truly *due* diligence before foreclosing. Lenders should engage qualified consultants and obtain legal advice before foreclosing on contaminated properties or properties suspected of contamination.

NOTES

[1] 42 U.S.C. §§ 9601-9675.

[2] The statutory protections and exemptions for lenders now found in CERCLA were largely a result of Congress' swift reaction to the Eleventh Circuit's decision in *Fleet Factors*, in which the court held that a lender could be strictly liable under CERCLA if it had merely the *capacity* to exercise control over its borrower's waste disposal practices, even if it did not actually do so. *See United States v. Fleet Factors Corp*., 901 F.2d 1550 (11th Cir. 1990).

[3] *See*, *e.g., State of New York v. Shore Realty Corp*., 759 F.2d 1032, 1042 (2d Cir. 1985) ("Congress intended that responsible parties be held strictly liable, even though an explicit provision for strict liability was not included in the compromise").

[4] *See*, *e.g., O'Neil v. Picillo*, 682 F. Supp. 706, 724 (D.R.I. 1988) ("It is now quite well settled that liability under CERCLA is joint and several").

[5] 42 U.S.C. § 9607(a).

[6] *Id*.; 42 U.S.C. § 9613(f); *see also U.S. v. Atlantic Research Corp*., 551 U.S. 128 (2007).
[7] 42 U.S.C. § 9601(20)(A)(iii).
[8] *Id*. at § 9601(20)(E)(ii).
[9] *Id*. at § 9601(35)(B)(i).
[10] 42 U.S.C. §§ 6901-6992k.
[11] *Id*. at §§ 6928, 6972.
[12] *Id*. at § 6991b(h)(9).
[13] *Id*. at § 6972.
[14] *See*, *e.g.,* Joe Rauch, *Banks Face Environmental Fines from Foreclosed Subdivisions*, Atlanta Business Chronicle, Oct. 24, 2008, http://Atlanta.bizjournals.com/Atlanta/stories/2008/10/27/story3.html (describing fines levied by state and local regulators on banks foreclosing on construction sites due to the banks' failures to control on-site erosion).
[15] 33 U.S.C. §§ 1251-1387.
[16] *Supra* note 14; *see also Gainesville Bank & Trust v. Conservation Land Developers, LTD*, *et al*., No. 06-CV-2568 (Forsyth, Ga. Cnty. Ct., dismissed June 13, 2008).
[17] 42 U.S.C. §§ 7401-7671q.
[18] 33 U.S.C. § 1365.
[19] 42 U.S.C. § 7604.
[20] Cal. Health & Safety Code §§ 25300-25395.45.
[21] *Id*. at § 25548.2(a)(1).
[22] *Id*. at § 25548.5(l).
[23] 42 U.S.C. § 9601(20)(E)(ii).
[24] *See*, *e.g.,* Schnapf, "Environmental Lender-Liability Statutes: Review of the States," 10 Comm'l Lending Rev. 54 (Spring 1995).
[25] Cal. Civ. Code § 2929.3(a)(1).
[26] Department of Toxic Substances Control, Fact Sheet, "Managing Hazardous Waste at Foreclosed Properties" (Oct. 2008).
[27] Georgia Department of Natural Resources, Environmental Protection Division, General Permit No. GAR100001. Available at http://www.gaepd.org/Documents/construction_stormwater.html (follow "Final NPDES General Permit No. GAR100001 For Stand Alone Construction Projects" hyperlink) (last visited Aug. 10, 2010).
[28] Cathedral City Municipal Code §§ 13.135.010-13.135.140 (2008).
[29] *Edwards v. First Nat'l Bank of North East*, 122 Md. App. 96, 712 A.2d 33

(Md. Ct. Spec. App. 1998).
[30] Md. Code Ann., Envir. § 4-401(i)(2)(i)(2) (West 2006).
[31] *Edwards*, 122 Md. App. at 109-10.
[32] *F.P. Woll & Co. v. Fifth and Mitchell St. Corp., No*. CIV.A.96-5973, 1997 WL 535936 (E.D. Pa. July 31, 1997).
[33] *Id*.