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AN ENVIRONMENTAL AND ENERGY LAW PRACTICE

DISTRESSED ASSETS AND FORECLOSED PROPERTIES: AVOID ENVIRONMENTAL LIABILITY RISKS

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In-house lawyers whose work remotely touches upon the areas of real estate or financial services should carefully assess the legal liability ramifications associated with distressed asset investment and foreclosure. In particular, lenders, investors and their counsel should seek to identify both the liability risks and protections afforded by environmental laws before these transactions occur.

Under environmental statutes, lenders can unwittingly become liable for remediation obligations at secured or foreclosed properties. The Comprehensive Environmental Response Compensation and Liability Act ("CERCLA") establishes categories of "potentially responsible parties" ("PRPs") liable for cleanup at contaminated sites, including current owners or operators. Liability under CERCLA and analogous state statutes is strict and joint and several. Importantly, CERCLA contains a secured creditor exemption designed to exclude traditional lending activities from its web of liability. The secured creditor exemption was added by Congress to address concerns that lending institutions would be deemed CERCLA "operators" of contaminated collateral by participating in their borrowers businesses or "owners" by foreclosing on collateral.

The secured creditor exemption works to ensure that traditional lending activities or workouts will not result in CERCLA liability unless an entity "exercises decision making control" over environmental compliance at the borrower's property, or exercise control over substantially all non-environmental functions. Thus, lenders are authorized to perform common activities including holding security interests, inspecting collateral, advising borrowers to prevent defaults, and even requiring borrowers to remediate contamination. Upon default, a lender can foreclose and continue to operate the collateral business operation without incurring CERCLA liability, so long as it seeks to divest the collateral "at the earliest practicable commercially reasonable time, on commercially reasonable terms," in light of market conditions and regulatory requirements.

Despite this environmental safe harbor, the secured creditor exemption is not without limitations. In a loan workout context, HSBC Bank agreed to a $966,000 settlement with New York State for contamination at a borrower's property where the state alleged that the lender restricted the borrowers uses of funds through a lockbox arrangement, including denying waste disposal expenditures that resulted in contamination. In a foreclosure scenario, the United States Environmental

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AVOID ENVIRONMENTAL LIABILITY RISKS (cont'd)

Protection Agency ("EPA") maintains that listing or advertising a property for sale within twelve months of foreclosure permits an entity to qualify for the secured creditor exemption. Real estate experts may question whether the twelve month window is reasonable in today's market conditions. Despite the secured creditor exemption, the specter of environmental liability and daunting remediation obligations associated with foreclosed property could concern potential investors and further reduce collateral value.

With these concerns in mind, clients should be counseled to take potentially protective measures including but not limited to:

- Conducting environmental due diligence: Foreclosing entities should carefully assess the environmental condition of the collateral that could result in a reduction of collateral value or give rise to environmental liability once the lender takes title to the property. Similarly, buyers of distressed assets need to conduct their own due diligence and not rely on the representations and warranties of a seller that may soon be out of business. To the extent possible, a Phase I Environmental Assessment in accordance with the federal "All Appropriate Inquiry" regulatory standard (40 C.F.R. 312/ASTM 1527-05) should be conducted as soon as foreclosure is contemplated. In some scenarios, obtaining Phase II subsurface groundwater and soils sampling may be necessary. A lender should further evaluate environmental issues that fall outside the scope of the All Appropriate Inquiry/ASTM 1527-05 standard including asbestos, lead based paint and radon.

- Avoiding "participating in the management of the facility": Lenders/investors need to maintain their secured creditor exemption status by not exercising decision making control over matters of environmental compliance or exercising control over substantially all non-environmental functions. Because there is no bright line test on this issue, environmental counsel should be consulted before any actions are taken that could potentially destroy the exemption.

- Moving to divest the property as soon as possible after foreclosure: A foreclosing entity should seek to divest its collateral as soon as possible, and at a minimum, list or advertise the property within twelve months of foreclosure.

- When industrial facilities are at issue, consider ongoing environmental compliance issues: Outside of CERCLA, if an investor acquires a distressed industrial asset that it seeks to continue operating as an ongoing concern, carefully evaluate whether existing environmental permits are sufficient and how such permits can be transferred to the acquiring entity. As a distressed asset, the former operator may have let necessary permits lapse or failed to pay required fees which could result in penalties or stop-work orders directed at the new owner.

Whether your client is a real estate investment trust moving swiftly to acquire troubled assets or a lending institution forced to foreclose on collateral property with environmental issues, it is imperative to ensure that all measures are taken to reduce the risk of environmental liability going forward.