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## Attorney

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# Buyers Beware: Environmental Secured Creditor Protections in the Distressed Loan Market

Nationwide, investors are raising capital for an eventual plunge into the distressed real estate assets market. While many deals remain on hold, real estate investment trusts and other investors will eventually acquire troubled assets.

Some believe that buyers will target distressed commercial whole loans—where the investor purchases commercial mortgage notes and assumes all of the lender's rights and responsibilities—which may be easier to value than mortgage-backed securities.

My colleague Jonathan Spergel recently wrote about potential environmental liability issues to consider when evaluating distressed assets ("The Environment Surrounding the Purchase of Distressed Assets," MAREJ July 10, 2009). With investors poised to acquire troubled commercial loans, today's article will explore one facet in more detail: the scope, benefits, and potential pitfalls of environmental liability protections for secured creditors.

### The Problem

Under the rigorous environmental cleanup liability scheme, lenders can sometimes fall into remediation obligations at secured or foreclosed properties. The primary federal law is the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). CERCLA establishes categories of potentially responsible parties (PRPs) liable for cleanup at contaminated sites, including current facility "owners" or "operators." Liability under CERCLA, and many analogous state statutes, is strict (regardless of fault) and joint and several (any PRP can be held responsible for the entire cleanup cost, even if others exist). Further, CERCLA provides only limited defenses.

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For several years, lenders were concerned about incurring CERCLA liability at mortgaged property. Spurred by ominous judicial rulings, banks feared that they could be deemed CERCLA "operators" of contaminated collateral by participating in their borrowers' businesses, or "owners" by foreclosing on collateral.

### The Solution

To allay lender fears, Congress added a "secured creditor exemption" to CERCLA in 1996, excluding traditional lending activities from CERCLA liability. Whether during loan workouts or afterwards, a lender will not be deemed a CERCLA "operator" unless the lender "exercises decision making control" over environmental compliance at the borrower's property, or exercises control over substantially all non-environmental operational functions. The statute authorizes lenders to perform common activities including holding security interests, inspecting collateral, advising borrowers to prevent defaults, and even requiring borrowers to remediate contamination.

Moreover, upon default, a lender may foreclose and continue the business operation without incurring "owner" liability if 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. Thus, a lender may foreclose on collateral and take actions to divest it, including maintaining or winding up business activities, performing a cleanup, or otherwise preparing the property for sale, while avoiding CERCLA liability.

Because CERCLA defenses do not affect state laws, several states have enacted similar protections. In this region, Pennsylvania and New Jersey provide fairly comprehensive secured creditor protections, while Delaware's is more limited.

### Potential Pitfalls

Although environmental safe harbors have given lenders comfort in financing or foreclosing on contaminated property, the boundaries of acceptable conduct are not always clear. For instance, in the loan workout context, HSBC Bank recently agreed to a $966,000 settlement with New York State for contamination at a borrower's property. The state alleged that HSBC restricted its borrower's uses of funds through a lockbox arrangement, including denying waste disposal expenditures that resulted in contamination.

On foreclosure, questions can include what constitutes commercially reasonable efforts to divest foreclosed property. The federal Environmental Protection Agency asserts that listing or advertising property for sale within 12 months of foreclosure satisfies the CERCLA defense; under New Jersey's law, the lender must actually sell the property within five years unless it meets certain conditions.

These examples illustrate that secured creditor protection provisions, while valuable, cannot eliminate all risk of lender cleanup liability under federal or state law. Further, even if a lender is protected, fear of liability by potential purchasers could reduce collateral value. Accordingly, investors eyeing distressed loans should evaluate how potential environmental costs could impact their bottom line.

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