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Lender Liability Under Environmental Laws in Real Estate Transactions

Why should real estate lenders and other secured creditors concern themselves with known and potential environmental liabilities and requirements associated with their loan portfolios? After all, environmental liabilities and requirements generally are imposed on borrowers who own and operate the real estate collateral securing the loan, and several liability protections exist in federal and state laws that are designed to specifically protect secured parties from incurring environmental liabilities simply because they took actions to protect their assets.

THOSE PROTECTIONS NOTWITHSTANDING, THERE ARE, in fact, several reasons why lenders need to remain vigilant regarding environmental risks. First, a borrower’s potential environmental costs and liabilities, particularly those associated with remediating contaminated sites and achieving and maintaining compliance with environmental laws, can be significant and can impact cash flow and, therefore, adversely impact a borrower’s ability to repay its loan. In addition, environmental laws can impose liability risk on mortgage lenders and other secured creditors who foreclose on and repossess property used to secure loans and run afoul of the statutory safe harbors available under such laws. Finally, lenders may not want to foreclose on contaminated property that cannot later be sold, or even be associated with contaminated property that may be stigmatized or pose a risk to the local community. This article discusses the risks that real estate lenders and other secured creditors face under various environmental laws and offers practical advice for mitigating such risks.
Lender Liability Risks Under Environmental Laws

A lender holding a security interest in real estate collateral can face multiple environmental risks. A borrower’s potential environmental costs and liabilities, particularly the cost of complying with environmental laws and remediating contaminated sites, can be significant, which can impact the borrower’s ability to repay its debt. In addition, environmental conditions, most notably soil and groundwater contamination, can adversely impact the value of the collateral and must be assessed both before issuing a loan and in advance of any potential foreclosure. This is because, under certain circumstances, a lender that acquires contaminated property through foreclosure or similar means could incur liability for any required remediation.

As a general rule, the mere lending of money and the taking of a security interest in real estate should not result in lender liability for contamination associated with the real estate; however, lenders who overstep this role may find themselves incurring liabilities. Prior to foreclosure, lenders can be held liable under environmental laws, such as the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), when found to have acted more like an owner or operator by participating in the management of the property. In addition, lender environmental liability risks can intensify when foreclosure is necessary, as statutory protections can disappear if a lender fails to sell or divest itself of the facility at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements. Furthermore, secured creditor protections generally do not extend to costs associated with continuing or prospective compliance obligations, such as air emissions or wastewater discharges from the foreclosed-upon site, and will not protect a lender from common law liability, such as claims for toxic torts, nuisance, or neighboring property damages. As such, environmental risks can increase the longer a property is held by the lender post-foreclosure.

Overview of Liability and Lender Protections Under CERCLA

CERCLA, commonly known as Superfund, is the primary U.S. federal law imposing liability for the investigation and remediation of contaminated properties. 42 U.S.C. § 9601 et seq. Under CERCLA, owners of real property generally are liable for the cost of addressing onsite contamination, regardless of fault. Liability under CERCLA is “strict,” which means that parties can be held liable without regard to fault, and “joint and several,” which means that a responsible party can be held liable for all cleanup costs, although such party may be able seek contribution from other parties potentially responsible for the contamination. For lenders, the practical consequence of CERCLA’s liability scheme is that the owner or operator of a property can be held liable for remediation costs even if the contamination pre-dated its ownership or operation of the contaminated property. Because there was a risk that a secured creditor could be viewed as an owner under certain state laws, CERCLA includes a specific exemption—often referred to as
a “safe harbor” from liability for secured creditors—that can shield lenders from both pre- and post-foreclosure liability with respect to real property collateral. We recommend that real estate lenders carefully follow the requirements for these defenses, which are described in detail below. Otherwise, the lender could risk incurring CERCLA liability as an owner or operator for (1) participating in the management of the borrower prior to the foreclosure or (2) by owning or operating the property after foreclosure.

Although CERCLA exempts from the definition of an owner a “person, who without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility,” a number of court cases in the early 1990s called into question the extent of this general exemption from liability for secured lenders. In 1996, after several years of lobbying by the financial services and real estate industries, Congress passed the Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996 (the Act), which amended CERCLA to provide lenders and fiduciaries with significant protections against being held liable for the environmental obligations of borrowers and beneficiaries. Pub. L. No. 104-208, § 2501, 110 Stat. 3009, 3009–469 (codified at 42 U.S.C. § 9601(20). Among other things, the Act amended CERCLA to (a) define what is and is not “participation in management” and (b) allow a lender to foreclose and take certain actions with respect to the property without losing liability protections.

Pre-Foreclosure Lender Liability

The Act’s passage essentially established a two-prong test for qualifying for lender liability protections: first, a person must qualify as a lender, and second, a person must not participate in management of the facility in question. In order to qualify for protection under the Act, a lender must establish that it holds its security interest to secure the repayment of money or other obligation of another person. 42 U.S.C. § 9601(20)(G)(iv). Applicable security interests include “a right under a mortgage, deed of trust, assignment, judgment lien, pledge, security agreement, factoring agreement, or lease and any other right accruing to a person to secure the repayment of money, the performance of a duty, or any other obligation by a nonaffiliated person.” 42 U.S.C. § 9601(20)(G)(vi). The second prong requires lenders to show that they did not actually participate in the management of the property. 42 U.S.C. § 9601(20)(F). The Act specifically provides that to participate in management, and therefore run the risk of being liable as an owner/operator, a lender must “actually participate in the management or operational affairs of a vessel or facility.” 42 U.S.C. § 9601(20)(F)(i)(I) (emphasis added). A lender is determined to have participated in management if it:

- Undertakes decision-making control or responsibility for the facility's hazardous substances handling or disposal practices —or—
- Exercises managerial control over day-to-day decision making with respect to environmental matters or the “operational functions” of the facility “other than the function(s) of environmental compliance”

Operational functions are defined to include “a function such as that of a facility or plant manager, operations manager, chief operating officer, or chief executive officer.” 42 U.S.C. § 9601(20)(G)(v). The Act distinguishes “operational functions” from “financial or administrative functions,” which are defined to include “a function such as that of credit manager, accounts payable officer, accounts receivable officer, personnel manager, comptroller, or chief financial officer or a similar function.” 42 U.S.C. § 9601(20)(G)(ii). The Act further specifies that many of the activities that lenders routinely perform in administering a loan do not constitute participation in management. Under the Act, a lender is not participating in management if it does any of the following:

- Holds, abandons, or releases a security interest
- Includes a covenant or warranty of environmental compliance in a loan or security instrument
- Monitors or enforces the terms and conditions of a loan instrument
- Monitors or inspects the facility
- Requires the borrower to take an environmental response action to address a release or threatened release of hazardous substance (e.g., requires the borrower to clean up contamination)
- Provides financial or other advice to the borrower to mitigate or cure a default or to prevent diminution in the value of the collateral
- Restructures or renegotiates the terms of the loan or security interest
- Exercises remedies available for breach of a condition of the loan— or—
- Performs a response (or cleanup) action either under Environmental Protection Agency (EPA) or state oversight or in accordance with Section 107(d) of CERCLA

Since the secured interest exemption was modified by Congress, there has been limited case law assessing what lender activities constitute participation in management; however, the following matter illustrates there are situations in which regulators will seek to impose environmental liability on lenders. In New York v. HSBC USA, N.A. (S.D.N.Y.)
No. 07–3160, 2007), the State of New York filed suit against HSBC alleging that HSBC was liable under CERCLA because it participated in the management of a facility and operated the site at a time when hazardous materials were being disposed of and released into the environment. HSBC did not file an answer in the case and later agreed to a consent decree. At issue was contamination at what historically had been the Westwood Chemical Corporation site in Wallkill, NY. Westwood previously had entered into an agreement with HSBC for a loan and line of credit secured by a mortgage and lien on the real property and on other Westwood assets, including accounts receivables, equipment, and personal property. The state’s complaint alleged that Westwood defaulted on the loan in 2003, and in 2004, HSBC changed Westwood’s cash management so that Westwood’s customers were paying HSBC directly. No payments or withdrawals could be made from the funds sent to HSBC without HSBC approval. Later, in October 2004, HSBC exercised its rights under the loan agreement and seized Westwood’s operating cash from the lock box without notice to Westwood’s management. According to the complaint, HSBC later refused requests for funds needed for the disposal of hundreds of containers of hazardous materials, which were
Other Related LexisNexis Resources

For coverage of environmental permitting and compliance issues, see
1-5A Environmental Law Practice Guide § 5A.03.

For a detailed discussion of lender liability, including liability under
CERCLA, RCRA, and state environmental cleanup laws, see
3-18 Environmental Law in Real Est. & Bus. Transactions
§ 18.01 et seq.

For a general discussion of lender liability, see
1A-7 Environmental Law Practice Guide § 7.05.

For more on mold, see
1-15A Environmental Law in Real Est. & Bus. Transactions
§ 15A.04 and 5A-36C Environmental Law Practice Guide
§ 36C.01 et seq.

For more on radon, see
1-15A Environmental Law in Real Est. & Bus. Transactions
§ 15A.02 and 3-17A Environmental Law Practice Guide
§ 17A.02[2].

For complete coverage of asbestos in commercial buildings, see
2-15 Environmental Law in Real Est. & Bus. Transactions §
15.01 et seq. and 5A-36 Environmental Law Practice Guide
§ 36.01 et seq.

For a general discussion of the implications for owners of buildings
and property contaminated with lead-based paint, see

And for a discussion on the disclosure of lead-based paint hazards
in the sale or lease of residential property, see
2-14 Environmental Law in Real Est. & Bus. Transactions
§ 14.04A.

For environmental reporting and notification forms pertaining to
lead-based paint, see
2-14 Environmental Law in Real Est. & Bus. Transactions
§ 14.08[1] (sample contract contingency clause re: lead-
based paint hazards) and 2-14 Environmental Law in Real
Est. & Bus. Transactions § 14.08[3] (sample disclosure form:
lead-based paint hazards (seller’s)).

For more on jurisdictional wetlands, see
1-9 Environmental Law in Real Est. & Bus. Transactions
§ 9.02 and 4-19 Environmental Law Practice Guide § 19.03.

For an in-depth discussion of wildlife and habitat protection, see
4-24 Environmental Law Practice Guide § 24.01 et seq.

For more on emerging issues in environmental due diligence, see
3-20 Environmental Law in Real Est. & Bus. Transactions
§ 20.04[6].
required to be removed from the closed site. Moreover, the state alleged that the heat for the building was turned off due to the lender’s refusal to pay utility bills, which resulted in further damage to the site related to freezing pipes and leaking hazardous materials. The state contended HSBC’s actions—including taking control of Westwood’s finances, refusing to fund an orderly shutdown plan, refusing to fund shipment of finished chemical products and the completion of work in progress, retaining contractors to perform work at the site, and otherwise exercising control over the site directly and/or indirectly—caused the abandonment, disposal, release, and threat of release of hazardous waste and hazardous substances to the environment from the site. Ultimately, the lender agreed to pay $850,000 in civil penalties and $115,680 in costs to settle the matter. Although no judicial precedent was created, the matter provides additional context as to what can be considered participation in management and shows that there are situations where regulators will seek to hold lenders accountable for environmental matters associated with real property collateral.

Post-Foreclosure Lender Liability

The Act also created a safe harbor from CERCLA liability for lenders who foreclose and become owners of the contaminated property. The Act specifies that, in order to qualify for this protection, the lender must not have participated in management of the facility prior to the foreclosure. This is because a party that could already be held liable under CERCLA as an operator should not be eligible for the safe harbor. After foreclosure, the lender must attempt to divest the property at the “earliest practical, commercially reasonable time, on commercially reasonable terms.” In this respect, a lender must not reject a bona fide offer of fair consideration or outbid other bidders. 42 U.S.C. § 9601(20)(E)(ii). Under this safe harbor provision, the lender can act as the owner of the property during the pre-divestiture period, including taking actions to sell the property, maintain business activities, or wind down the operations of a company. 42 U.S.C. § 9601(20)(E)(ii)(II). From an environmental perspective, a lender that has foreclosed upon a property may address the release or threatened release of a hazardous substance and take soil and/or groundwater samples at the property without jeopardizing the safe harbor protections. Northeast Doran v. Key Bank, 15 F.3d 1 (1st Cir. 1994). That said, since very limited judicial guidance exists, there is no clear-cut rule for what lender actions in the context of a foreclosure or potential foreclosure would be considered as acceptable under the safe harbor. One federal district court held that a lender was not subject to CERCLA liability when, before foreclosure, it listed the property for re-lease, leased a portion of the site, and communicated with environmental firms about the extent of site contamination and cleanup-cost estimates. U.S. v. Pessess, 1998 U.S. Dist. LEXIS 7902 (W.D. Pa. May 6, 1998).

The Act also fails to specify what constitutes commercially reasonable efforts to divest property; however, the EPA has provided guidance, stating that the “test [of commercially reasonable efforts to divest an interest in property] will generally be met if the lender, within 12 months of foreclosure, lists the property with a broker or advertises it for sale in an appropriate publication.” EPA, Handbook of Tools for Managing Federal Superfund Liability Risks at Brownfields and Other Sites, 11–13, 25–26 (1998), available at http://nepis.epa.gov.

Available guidance does not address potential consequences of the inability to sell a foreclosed upon property within a given period of time. As such, a lender seeking to assert the security interest exemption should carefully document its efforts to manage, market, and sell the foreclosed upon property in order to factually establish it was actively marketing the property and that any actions the lender takes with respect to managing the property were directed at preserving the value of collateral.

Lenders should be aware that even if their pre- and post-foreclosure actions with respect to a property fall squarely within the secured creditor exemption prescribed under the Act, environmental liability can still impact the lender in several ways. First, even if the lender qualifies for the secured creditor exemption under CERCLA, similar protections may not be available to prospective buyers, which means that contamination at the property is likely to decrease the property’s resale value. In addition, as discussed below, other federal and state laws may also apply and impose liability for contamination. While some of these laws have protections that parallel the CERCLA secured creditor exemption, lenders should assess potential liability under each on a case by case basis. Finally, the CERCLA secured creditor exemption does not cover costs and liabilities associated with compliance with environmental laws at an operating facility. Lenders foreclosing on an operating facility will need to comply with applicable regulations such as those covering air, water, and waste discharges. For example, a lender that forecloses on an operating facility that discharges wastewater under a wastewater discharge permit or has substantial air emissions governed by an air permit will be responsible for maintaining compliance with those permits.

Lender Liability Under RCRA

Another potentially significant source of environmental liability for lenders is the federal Resource Conservation and Recovery Act (RCRA), which regulates the generation, storage, handling, transportation, and disposal of hazardous waste. 42 U.S.C. §§ 6901–6992k. Owners or operators of facilities that treat, store, or dispose of hazardous wastes must comply
with certain operating standards and may also be required to undertake corrective action to clean up contamination caused by hazardous or solid wastes pursuant to a permit or a corrective action order. The government also may issue orders for injunctive relief to address hazardous wastes posing an “imminent and substantial endangerment” to public health and the environment. RCRA does not contain the same broad exemption from liability for secured creditors as found in CERCLA. Therefore, a lender who forecloses on a property where leaking drums of waste are buried or actively participates in the management of the borrower’s facility could face claims alleging that it is an owner or operator who is contributing to the disposal of hazardous or solid waste.

The 1996 Lender Liability Act, which addressed lender liability under both CERCLA and RCRA, does provide an important exception to lender liability under RCRA’s Subtitle I, which pertains to petroleum underground storage tank (UST) systems. Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 (H.R. 3610), subtit. E, §§ 2501 to 2505, at H11766; 60 Fed. Reg. 46,692 (Sept. 7, 1995); 40 C.F.R. § 280.200. This exception makes clear that a person holding a security interest in a UST system is exempt from compliance with UST regulatory requirements from the time a loan is issued through foreclosure, loan workout, and the ultimate disposition of assets. In other words, the secured-creditor exemption under RCRA for petroleum USTs generally follows the protections of the amended fiduciary and lender provisions of CERCLA. The Act amends 42 U.S.C. § 6991b(h) to exclude from the RCRA definitions of owner or operator anyone who holds a security interest in property with USTs but who does not participate in the management of those tanks and who is not in the petroleum production, refining, or marketing business. Therefore, absent evidence of participation of management, persons merely holding a security interest in property containing an UST will not be considered to be an owner or operator for purposes of the UST provisions of RCRA. Despite this exception, lenders should remain aware that if lenders’ activities, particularly during foreclosure, violate other RCRA provisions, such as those found in Subtitles C or D pertaining to solid and hazardous waste permitting and management, RCRA liability may be incurred.

Lender Liability Under the Clean Water Act

The Clean Water Act (CWA) regulates the discharge of pollutants into waters of the United States by, among other things, prohibiting discharges of pollutants without first obtaining a National Pollutant Discharge Elimination System (NPDES) permit. The NPDES program requires various permits for different point source discharges, including stormwater discharges from a construction site, the most relevant scenario for this article. EPA or the state permitting authority requires stormwater permits from all property owners and the general contractor for a typical construction or development project. Generally, these types of permits require permittees to develop a stormwater pollution prevention plan (SWPPP), conduct monitoring, and incorporate best management practices to control and limit stormwater discharges. Failure to comply with these obligations can result in fines and penalties, civil suits, or even criminal charges.

Unlike CERCLA and RCRA, the CWA does not have a secured creditor exemption. As such, lenders will be considered owners or operators of foreclosed upon properties and will be responsible for complying with regulations promulgated under the CWA, which could include the lender obtaining a new stormwater discharge permit. Moreover, the lender could be held liable for any preexisting and/or ongoing violations incurred by the borrower at the now foreclosed upon site. A few states have recognized this potential issue and issued guidance clarifying the states’ positions regarding lender liability under the CWA. For example, the Minnesota Pollution Control Agency released an overview regarding its stormwater program aimed at, among others, “a bank taking ownership of an unfinished, foreclosed building project,” which states that a lender who forecloses on a site has the same responsibilities as the former property owner. See [link]http://stormwater.pca.state.mn.us/index.php/Owner_Responsibilities_Under_the_Construction_Stormwater_Permits. Guidance also can be found in state permits issued under the CWA. For example, Georgia’s NPDES general permits include the statement “[i]n the event a lender
or other secured creditor acquires legal title to the facility/construction site, such party must file a new Notice of Intent to be covered under the permit in accordance with this Part by the earlier to occur of (a) seven (7) days before beginning work at the facility/construction site; or (b) thirty (30) days from acquiring legal title to the facility/construction site.” See https://gaswcc.georgia.gov/npdes-permits.

Lender Liability Under State Laws

Although a discussion of each individual state’s environmental liability schemes is beyond the scope of this article, lenders should be aware that state environmental laws can create similar environmental liability risks for lenders who foreclose and repossess property used to secure loans. Laws such as CERCLA and RCRA do not preempt state laws governing the cleanup of hazardous substances, and many states have enacted statutes which either closely track the language of CERCLA and RCRA or incorporate it by reference, and which courts have interpreted in light of the well-settled constructions of similar provisions in the federal law. Thus, to the extent that a state has a statute with language that incorporates by reference or closely parallels the security interest exemption of CERCLA or RCRA, a court construing that statute might consider guidance and decisions evaluating the federal secured creditor exemptions discussed above to be persuasive authority as the correct interpretation of the state law exemption. Kemp Indus., Inc. v. Safety Light Corp., 857 F. Supp. 373, 397–98 (D.N.J. 1994) (interpreting N.J. Stat. Ann. § 58:10-23.11g5, which is New Jersey’s secured creditor exemption).

Financial Risks to Lenders—Environmental Liabilities Can Adversely Impact a Borrower’s Ability to Repay Its Loan

Putting aside the risk of lender liability, lenders who take a security interest in real estate should be cognizant that environmental liabilities can materially impact not only the collateral, but also the borrowers’ cash flow, which in turn, can adversely impact the borrowers’ ability to repay loans. Such risks can manifest in various ways at a borrower’s property and relate primarily to contamination or compliance concerns. On the contamination front, lenders should understand whether known or yet-to-be-discovered soil or groundwater contamination at the property could lead to expensive investigation or cleanup obligations incurred by the borrower. If such concerns exist, lenders may need to evaluate the collateral package to ensure that the value of the collateral, less potential environmental costs, is not less than the value of the loan. Likewise, contamination at a borrower’s property can give rise to third-party tort liability for personal injury related to exposure to the contamination or property damage related to the onsite contamination or for contamination that migrates from the borrower’s site to neighboring sites. Contamination migrating from a borrower’s property can result in significant liabilities, particularly when the contaminants migrate into a residential area or beneath an environmentally sensitive property, such as a school or hospital.

Known or prospective compliance obligations can also impact a borrower’s bottom line, particularly in transactions where properties will be occupied by manufacturers or other businesses that handle large quantities of hazardous materials. Failure to comply with environmental laws could result in the borrower incurring fines or penalties, contamination, or revocation of a permit necessary to operate. Likewise, borrowers can incur substantial costs to achieve or maintain compliance with environmental laws. For example, borrowers with substantial air emissions may be forced to purchase and install expensive emissions control equipment to achieve compliance with air emissions laws that typically become more stringent over time, and borrowers with significant wastewater discharges could be required to upgrade a site’s wastewater treatment system in order to meet permitted wastewater discharge parameters. A proper due diligence review allows a lender to assess whether known or contingent environmental liabilities could impair a borrower’s ability to repay the loan.

Done right, a lender’s environmental due diligence review should mitigate the environmental risks inherent in making a loan. While a thorough discussion of the environmental due diligence process for a real estate loan is beyond the scope of this article, such review should be designed to help assess
the value of the borrower’s property (particularly pledged property) and determine whether environmental liabilities and compliance costs might be expected to impair the value of the lender’s collateral and/or the borrower’s ability to repay the loan. Due diligence also enables the lender to identify any known or potential environmental conditions that could affect the appeal of foreclosing on property to realize the value of the collateral or create potential environmental liabilities or adverse publicity for the lender. The lender may conduct its own investigation, rely on the due diligence of the borrower, or use a combination of both where it hires a consultant to peer review the borrower’s reports. If a lender relies on the borrower’s diligence, the lender should carefully consider the adequacy of the borrower’s review. If the borrower has sponsored independent technical reviews, such as Phase I Environmental Site Assessments (Phase I ESAs), the lender should obtain reliance letters allowing the lender to rely on the contents of the reports. Diligence done at the time the loan is made should be revisited prior to foreclosing as the condition of the property may have changed such that taking title—despite lender liability protections—is not desirable or runs afoul of internal practices and procedures.

A lender’s due diligence review should be tailored to the address the nature of the transaction, the particular borrower’s financial condition, and the nature of the collateral and potential environmental liabilities, and generally should consider the following:

- Risk of contamination at the property from on-site and off-site sources, including the potential for vapor intrusion
- Building-related conditions that could impact use or present health and safety risks, including asbestos, radon, lead-based paint, water quality, and water intrusion and mold concerns
- The building’s and any operator’s compliance with current and pending environmental laws
- Site conditions that could delay or adversely affect developments or construction, such as contamination, wetlands or threatened and endangered species, archeological remains
- Emerging areas of environmental risks, such as energy efficiency, climate change risks, and water scarcity
- The lender’s own public commitments regarding sustainability

Making the Loan

Upon completion of its environmental due diligence investigation and in conjunction with the business due diligence, the lender should understand the creditworthiness of the borrower and the known and potential environmental liabilities affecting the real estate that will serve as collateral.
This knowledge will affect the value the lender will give to the real estate collateral and the obligations the lender may impose on the borrower to maintain or improve the value of the collateral. These obligations are typically set forth in the loan agreement (and sometimes in the mortgage or deed of trust if there isn’t a loan agreement for the transaction), which often includes the following:

- **Definitions.** Key terms, such as “Environmental Laws,” “Environmental Liabilities,” and “Hazardous Materials” are generally defined, and how the terms are defined may affect the scope of the loan agreement provisions. From a lender’s perspective, such definitions typically should be drafted broadly, assuming the parties agree that the loan agreement should cover all environmental liabilities under consideration.

- **Conditions Precedent.** The lender may seek to condition financing on receipt of satisfactory environmental assessments indicating the absence of significant or material environmental liabilities or the delivery of certain types of O&M programs if the building contains asbestos, lead-based paint, or mold or water intrusion risk. With respect to this condition precedent, a borrower typically will seek, at a minimum, a reasonableness standard, but would prefer some type of materiality standard, i.e., a report is acceptable if it does not reveal material liabilities. In contrast, a lender often wants absolute discretion to determine whether the environmental assessment is acceptable to satisfy the condition precedent.

- **Representations and Warranties.** The loan agreement contains statements, referred to as representations and warranties, as to the environmental condition of the real property collateral, including the operations at the property. Lenders use representations and warranties to better understand the environmental condition of the real property and to create a default mechanism should the representations and warranties turn out to be false. Finally, representations can be used to elicit due diligence information on the real property collateral to the extent a lender was not able to obtain the information during the due diligence review.

Environmental representations in real estate transactions generally cover the following subjects:

- Compliance with applicable laws, including compliance related to permits and other authorizations
- Pending or threatened suits, proceedings, investigations, or claims
- Current and historic use of the hazardous materials at the property
- Risks that conditions at other nearby sites could adversely affect the collateral
- Known and contingent liabilities related to contamination at the real property collateral – and –
- Specific issues, including the presence of USTs, polychlorinated biphenyls (PCBs), asbestos, lead-based paint, mold, or other features that are potential sources of risk

In order to reduce the risk of a breach, borrowers will attempt to curtail the scope of the environmental representations by using a materiality and/or knowledge qualification and a disclosure schedule. On certain representations, it typically is deemed fair to avoid creating a scenario where non-material or technical breaches of a representation, which will not materially impact the lender, create a default under the loan agreement.

- **Covenants.** If the due diligence identifies any issues that need to be addressed, such as the need to undertake remediation, install a radon-mitigation system, register a tank, or eliminate the source of water intrusion, the lender may require the borrower to do so in a covenant included in the loan agreement or by separate letter agreement. The covenant or letter agreement will typically provide a time frame for completion as well as requiring the estimated costs to be escrowed or held back from the loan proceeds. This way, the lender makes sure that the value of its collateral is being maximized.

In addition, because a real estate loan remains in place over time, the lender should include a covenant requiring the borrower to operate the collateral in compliance with environmental laws and to provide notice of certain events during the life of the loan (such as receipt of a notice of violation or an information request pertaining a notice of violation of environmental laws or a release of hazardous substance, in each case that could be expected to be material to the borrower) so that the lender may reevaluate its position in light of new events or otherwise take action to protect its collateral prior to the occurrence of significant environmental problems or liabilities. In circumstances where real property collateral is contaminated or significant environmental risks exist, a lender also may seek a covenant obligating the borrower to provide regular compliance updates or remediation status reports to the lender. Finally, the lender may negotiate the option of accelerating the loan in the event previously unknown material environmental liabilities arise. Generally, an acceleration clause is tied to events of default, which are in turn tied to breaches of the representations and warranties or covenants.
Indemnity. A lender will require a broad and unconditional indemnity provision from the borrower in the event the lender is held liable for contamination or any other environmental costs caused by the borrower’s activities or otherwise attributable to the operations of the borrower or the real property collateral. Borrowers, at a minimum, will generally not agree to indemnify the lender for any liabilities attributable to the gross negligence or willful misconduct of the lender, its agents, or representatives. Borrowers also often attempt to avoid the obligation to indemnify the lender for liabilities arising out of or related solely to the lender’s operation of the real property following a foreclosure.

Default Under the Loan Agreement

When a borrower has defaulted on its loan and attempts to restructure the loan terms through a workout are unsuccessful, the lender may decide that the best way to salvage value from the collateral and minimize its loss on the loan is to foreclose on the real property. As discussed above, foreclosing on potentially contaminated property presents risks and challenges for lenders.

Due Diligence in Advance of Foreclosure

Before deciding how to proceed, the lender should understand the present condition of the collateral and risks and liabilities that may arise out of its ownership of the property. This typically will involve conducting an environmental due diligence review, which, as discussed above, is scoped to investigate potential risks presented by a particular property. Such review should provide the lender with a better idea of how to price the property, whether environmental impairments have the potential to delay a sale, and whether the lender may incur costs associated with environmental compliance while it holds the property prior to sale. If material issues are identified, a lender could determine that the cost of rectifying the environmental issues exceeds the value of the collateral since in the foreclosure context, the borrower is unlikely to have the financial means to fund a cleanup, and known or potential contamination could reduce the lender’s net proceeds from a sale as prospective buyers insist on price reductions or other concessions to address the issues. In addition, the condition of the property may be such that internal practices and procedures at the bank do not allow foreclosure. Some lenders have internal procedures that prevent foreclosure on highly contaminated sites.

While the lender may be able to mitigate its statutory liability through some of the lender liability protections discussed above, the lender has practical considerations to take into account, which include how it divests the property as lenders are not in the business of holding onto real estate. Secured creditor protections do not extend to costs associated with continuing or prospective compliance obligations such as air emissions or wastewater discharges from the foreclosed-upon site, and will not protect a lender from common law liability, such as claims for toxic torts, nuisance, or neighboring property damages. During this time period the lender should also assess whether viable alternatives to foreclosure exist, such as suing the borrower on the underlying note, selling the underlying note and assigning the related security interest in the collateral to a third party, or facilitating a sale of the collateral by the defaulting borrower directly to a third-party purchaser. Doing so allows the lender to circumvent potential environmental liabilities associated with ownership of the collateral as well as concerns over whether the lender’s actions post-foreclosure satisfy the secured creditor exemption.

If, after conducting a pre-foreclosure environmental diligence review and evaluating potential liability scenarios, the lender decides that foreclosure is best way to proceed, and the site is contaminated, then the lender should follow the procedures outlined in the secured creditor protections and state environmental laws. As discussed above, a foreclosing lender avoids CERCLA liability if it makes reasonable efforts to sell the property at the earliest practical, commercially reasonable time, on commercially reasonable terms considering market conditions and legal and regulatory requirements. If the lender makes a reasonable attempt to sell the property in this manner, and avoids participating in the management of the property prior to the foreclosure action, the lender generally can take the following actions after foreclosure: maintain business activities; wind down operations; sell, re-lease or liquidate the property; and address the release or threatened release of a hazardous substances at the property.

Best Practices for Avoiding Lender Liability in Real Estate Transactions

As discussed above, secured creditor liability, such as those found in CERCLA, RCRA, and analogous state statutes, arguably place real estate lenders in a better position than other parties that may be subject to liability under federal and state environmental laws. That said, the protections afforded by such exemptions are not comprehensive, and the exemptions can be voided by certain lender actions. In addition, lenders who foreclose also can be subject to additional risks related to compliance with environmental laws that will not protect a lender from common law liability, such as claims for toxic torts, nuisance, or neighboring property damages. Finally, real estate lenders should consider reputational risks when considering whether to finance the purchase of or foreclose upon contaminated property that may be stigmatized or pose a risk to the local community. In order to minimize the risk of
incurred environmental liabilities, we recommend that real estate lenders follow the best practices outlined below:

- **Conduct an Environmental Due Diligence Review of the Real Estate Collateral Prior to Extending Financing or Foreclosing on a Property.** An environmental due diligence review should be designed to assess the value of the pledged collateral property and confirm whether environmental liabilities and compliance costs might affect the value being assigned to the collateral as well as the borrower’s ability to repay the loan. The lender may conduct its own investigation or it can rely on the due diligence of the borrower; however, if the lender relies on the borrower’s diligence, the lender should carefully consider the adequacy of the borrower’s review. A pre-foreclosure due diligence allows lenders to confirm to what degree, if any, environmental issues decrease the value of collateral or complicate the timing of a sale. Prior to foreclosure, lenders also should assess the legal impact of foreclosing on a property and whether placing itself in the chain of title of a contaminated property exposes the lender to risks or liabilities, notwithstanding any legal protections that may exist.

- **Insist on Strong Environmental Risk Management; However, Avoid Active Participation in Management.** Real estate lenders should insist, to the extent feasible, that borrowers or their tenants employ strong environmental management programs and procedures to minimize environmental risks at the real property collateral. Likewise, after foreclosure, lenders should proactively verify that ongoing operations at the property are not creating new environmental liabilities or worsening existing conditions, and confirm that it is in compliance with all continuing compliance obligations under environmental laws. That said, since a lender who participates in management of the property prior to foreclosing can be held liable as an operator under CERCLA, lenders are advised to limit direct involvement in the borrower’s environmental matters and refrain from exercising decision-making control or responsibility for the facility’s hazardous substances handling or disposal practices.
In the Event of Default, Properly Evaluate Strategies for Limiting the Lender’s Potential for Incurring Environmental Liabilities After Foreclosing. Prior to foreclosing, lenders should evaluate the practical implications of foreclosing on environmentally impaired collateral—will contamination delay a sale to a third party or cost more to remediate than the property is worth—as well as the legal impact of foreclosing on a property and whether placing itself in the chain of title of a contaminated property exposes the lender to substantial environmental risks. Lenders should carefully consider the applicability of safe harbors under CERCLA, RCRA, and analogous state statutes. Moreover, it may be worth considering the feasibility of selling the underlying note and assigning the related security interest in the collateral to a third party or facilitating a sale of the collateral by the defaulting borrower directly to a third-party purchaser. In addition, other risk transfer mechanisms such as environmental insurance may make sense in certain transactions.

Document Facts Showing Lender Adherence to Secured Creditor Exclusions. To the extent a lender foreclosing on real property collateral plans to rely on the secured creditor exemptions, it should keep detailed records that support the lender’s observance of the applicable statutory defenses to liability. For instance, commercially reasonable efforts to resell foreclosed upon property should be documented and arguments supporting why purchase offers were rejected should be preserved.

Use Appropriate Contractual Terms When Documenting the Loan. Once risks have been evaluated and identified, lenders or their attorneys should address such risks through the loan-document drafting process. Real estate lenders should insist on including in the loan documents representations and warranties, covenants, and indemnities that are appropriate for the property at issue. Moreover, it may be appropriate to require periodic notices from the borrower providing status reports with respect to remediation projects or documenting ongoing compliance with environmental laws.

Annemargaret Connolly is a partner and head of the Environmental practice at Weil, Gotshal & Manges LLP. She is the general editor of Environmental Law in Real Estate and Business Transactions (Matthew Bender), a 3-volume treatise which is updated annually by attorneys at her firm and focuses on environmental issues that arise during real property and business transactions. Matthew D. Morton is counsel at Weil, Gotshal & Manges LLP.