SECURED CREDITORS: Exempt from Liability?

Bert Acken[*]

INTRODUCTION

Secured creditors can be exempted from liability for contamination from properties for which they hold security interests under the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA"),[1] the Underground Storage Tank ("UST") program under the Resource Conservation and Recovery Act ("RCRA")[2] and Arizona's CERCLA-counterpart, the Water Quality Assurance Revolving Fund ("WQARF").[3]

However, these protections are far from absolute and will be lost if applicable requirements are not followed while a loan is active, or after a lender acquires ownership or possession. Additionally, even if a lender follows the steps necessary to protect itself from cleanup liability, additional efforts should be undertaken before a loan is originated to protect a security interest to the fullest extent possible.

I. COMPREHENSIVE ENVIRONMENTAL RESPONSE, COMPENSATION, AND LIABILITY ACT

CERCLA, commonly known as Superfund,[4] imposes joint and several cleanup liability on a property's current and past owners and operators for contamination from hazardous substances.[5] Petroleum releases, such as those from UST located at gas stations, are not covered by CERCLA. Instead, petroleum UST releases are addressed under RCRA.[6]

---

*. Mr. Acken is a Shareholder with the law firm Ryley Carlock & Applewhite. Mr. Acken's practice focuses on environmental due diligence, environmental permitting and compliance, and siting of utility infrastructure projects. His full bio and contact information are available at http://www.rcalaw.com/aacken.

1. 42 U.S.C. § 9601 (2012).
2. 42 U.S.C. § 6991 (2012).
3. ARIZ. REV. STAT. ANN. § 49-282 (2014).
4. *CERCLA Overview*, EPA, http://www.epa.gov/superfund/policy/cercla.htm (last visited Mar. 31, 2014).
5. 42 U.S.C. § 9607 (2012); *id.* § 9601(14).
6. 42 U.S.C. § 9601(14); *id.* §§ 6991–6991m (2012).

A. Lender Liability Exemption

To facilitate lending for contaminated properties, CERCLA contains a well-known exemption from the owner/operator definition for "a person that is a lender that, without participating in the management of a . . . facility, holds indicia of ownership primarily to protect the security interest in the . . . facility."[7]

This so-called lender liability exemption applies to much more than just a bank loan secured by a mortgage or deed of trust. The term lender is broadly defined to include, among others, "any person . . . that makes a bona fide extension of credit to or acquires a security interest from a nonaffiliated person."[8]

While the intended scope of the exemption is broad, it is not infinite. In *Georgia-Pacific Consumer Products LP v. NCR Corp.*,[9] the court concluded that the seller did not hold title primarily to protect a security interest. Rather, the seller's goal was to "separate itself from operational responsibility . . . so even assuming for purposes of argument that the Lease transaction was a creative form of seller financing, the Court would still find by a preponderance of the evidence that [the] primary purpose in the transaction was not to protect a security interest, but rather to facilitate a series of transactions that would ultimately rid [defendant] of both operational and ownership responsibility."[10]

Assuming that a lender's interest is held primarily to protect a security interest, the next step is to make sure that the lender is not "participating in the management of a . . . facility."[11] The statutory regime explicitly excludes the following activities from the phrase:

1. Holding or abandoning a security interest;
2. Including a covenant, warranty, or other term or condition that relates to environmental compliance;
3. Monitoring or enforcing the terms and conditions of the extension of credit or security interest;
4. Monitoring or inspecting the facility;
5. Requiring a response action to address a release or threatened release;

---

7. 42 U.S.C. § 9601(20)(E) (2012); *see also id.* § 9601(20)(A).
8. 42 U.S.C. § 9601(20)(G)(iv) (2012).
9. No. 1:11-CV-483, 2013 WL 5428729, at *17 (W.D. Mich. Sept. 26, 2013).
10. *Id.*
11. *Id.*

6. Providing financial or other advice or counseling in an effort to mitigate, prevent, or cure default or diminution in the value of the facility;
7. Restructuring, renegotiating, or otherwise agreeing to alter the terms and conditions of the extension of credit or security interest;
8. Exercising other remedies that may be available under applicable law for the breach of a term or condition of the extension of credit or security agreement; or
9. Conducting a response action under 42 U.S.C. § 9607(d) or under the direction of an on-scene coordinator appointed under the National Contingency Plan.[12]

With the exception of the last item, this list covers a wide range of activities that a lender might typically undertake with respect to a security interest. However, a lender can go too far, and will be deemed to participate in management if it exercises decision-making control over environmental compliance at the facility or exercises control, comparable to a manager, to a degree that the lender has assumed responsibility:[13]

> for the overall management of the vessel or facility encompassing day-to-day decision-making with respect to environmental compliance; or
>
> over all or substantially all of the operational functions (as distinguished from financial or administrative functions) of the vessel or facility other than the function of environmental compliance.

Read together, these definitions demonstrate that a lender can monitor, require compliance, and even require a borrower to conduct a cleanup, but generally speaking, the lender cannot undertake or direct environmental compliance or cleanup without risking its exclusion.

B. Post-Foreclosure Obligations

Even if a secured creditor complies with all legal requirements prior to foreclosure, it must address a new set of challenges and requirements if it finds itself facing the difficult dilemma of a defaulting borrower with a contaminated property. Given the potential risks, walking away may look like

---

12. *Id.* § 9601(20)(F)(iv).
13. *Id.* § 9601(20)(F)(ii).

an appealing option, and a threshold question at this point is whether the estimated cleanup costs and other liabilities exceed the value of the property.

If the lender takes possession, there are additional requirements it must meet.[14] Fundamentally, a lender who takes possession must make sure it operates the facility in a way that does not cause or further contribute to contamination onsite. While it is in possession of the property, the lender can maintain business activities, wind-up operations, and take actions to preserve the property and prepare it for sale.[15]

However, in so doing, it could subject itself to "arranger" liability, which imposes cleanup liability on "any person who by contract, agreement or otherwise arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility or incineration vessel owned or operated by another party or entity . . . from which there is a release, or a threatened release . . . of a hazardous substance."[16] In simpler terms, if a lender arranges for the disposal of hazardous substances (whether or not the lender owns the hazardous substances) and there is a release or threatened release of those hazardous substances at the disposal site, the lender is liable for the cost of cleaning up the disposal site.

In addition, a lender must divest its interest "at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."[17] CERCLA does not specify what constitutes earliest practicable and commercially reasonable efforts of the lender to divest itself of the 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."[18] The guidance does not discuss the consequences of the

---

14. A Deed in lieu of foreclosure is treated as functionally equivalent to foreclosure under CERCLA. *See, e.g.*, Waterville Indus. v. Fin. Auth. of Me., 984 F.2d 549 (1st Cir. 1993).

15. U.S. ENVTL. PROT. AGENCY, CERCLA LENDER LIABILITY EXEMPTION: UPDATED QUESTIONS AND ANSWERS (July 2007), http://www2.epa.gov/sites/production/files/documents/lender-liab-07-fs.pdf.

16. 42 U.S.C. § 9607(a)(3)–(4) (2012).

17. 42 U.S.C. § 9601(20)(E)(ii).

18. *See* U.S. ENVTL. PROT. AGENCY, 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; *cf.* U.S. v. Pesses, No. Civ. A. 90–0654, 1998 WL 937235 (W.D. Pa. May 6, 1998) (in which a magistrate judge concluded that a lender who held property for fifteen years still qualified).

inability to sell within a given period of time, but clearly contemplates and implies that if a lender fails to list the property for sale within a year the lender will be expected to, insofar as it asserts the security interest exemption, provide a position and argument as to why, notwithstanding the time lapse for listing the property, the lender's conduct constituted commercially reasonable efforts to divest itself of the property as soon as practicable.

Because the term "commercially reasonable" is not defined, the lender with possession of foreclosed property should carefully document its efforts to market the property. These efforts may include some efforts to "prepare the property" for sale and delays in listing can be associated with unfavorable market conditions, although an undue delay, even in the face of unfavorable market conditions, can cause the exemption to be lost.

To provide an additional layer of protection, lenders often seek to install fiduciaries such as court-appointed receivers to avoid acquiring ownership. This will keep the lender out of the chain of title, but a receiver must be wary as CERCLA provides little to no protection beyond the receiver's general liability protections as an officer of the court. Although CERCLA limits the liability of fiduciaries to the value of the assets held in the fiduciary capacity, [19] the term "fiduciary" does not include "a person that acquires ownership or control . . . with the objective purpose of avoiding liability of the person or any other person."[20] Additionally, a fiduciary must be very careful that it only conducts activity in its fiduciary capacity.[21] The personal liability protection will also be lost if the fiduciary causes or contributes to the release through its own negligence.[22]

II. PETROLEUM-CONTAINING UNDERGROUND STORAGE TANKS

As discussed above, RCRA, not CERCLA, addresses petroleum. Like CERCLA, the UST statutes and regulations provide secured creditors (called "holders") with some liability protection. Generally speaking, as under CERCLA, a person or entity holding a security interest is largely exempt from complying with UST requirements.[23] However, like its CERCLA counterpart, the regime requires a lender to follow certain requirements while the borrower is in place and additional requirements if the lender takes control or ownership.

19. 42 U.S.C. § 9607(n)(1).
20. *Id.* § 9607(n)(5)(A)(ii)(II).
21. *Id.* § 9607(n)(5)(B).
22. *Id.* § 9607(n)(3).
23. *Id.* § 6991b(h)(9)(A) (2012).

Prior to foreclosure, the UST and CERCLA provisions are equivalent. The UST statutes apply CERCLA's provisions addressing secured creditors' liability.[24] As under CERCLA, the program exempts secured creditors from the definition of an owner/operator, so long as they do not participate in management as that phrase is defined under CERCLA's secured creditor provisions.[25]

However, once a lender takes control or ownership of a property, it may then become liable as an operator if there is no other person who can be held responsible for compliance.[26] If another operator does not exist, a lender is excused from some requirements otherwise applicable to operators if it empties known USTs within sixty days of foreclosure, empties newly discovered USTs within sixty days of discovery, and either temporarily or permanently closes the USTs in accordance with applicable requirements.[27]

If it complies with these requirements, a holder does not have to comply with UST corrective action requirements.[28] That said, a holder may determine that cleaning the site is worth the costs to improve the property's value.

III. ARIZONA WATER QUALITY ASSURANCE REVOLVING FUND

Arizona's corollary to the federal CERCLA program is WQARF.[29] Like CERCLA, WQARF excludes from the definition of owner/operator entities that maintain indicia of ownership primarily to protect a security interest.[30] Unlike CERCLA, liability is apportioned according to fault, as there is no joint liability. While this is unquestionably beneficial to lenders, who are unlikely to be responsible directly, in other ways, the WQARF program provides more limited protections for lenders. Specifically, a lender loses its liability protection if it:

1. Through intentional misconduct or gross negligence causes, contributes to, or aggravates the release of a hazardous substance.
2. Fails to disclose to the facility's purchaser the known presence of a release or a threatened

24. *Id.* § 6991b(h)(9)(B).
25. *Id.*
26. 40 C.F.R. § 280.230(b)(1) (2014).
27. *Id.* § 280.230(b)(2)–(3).
28. *Id.* § 280.230(b)(2).
29. ARIZ. REV. STAT. ANN. § 49-282 (2014).
30. *Id.* § 49-283(H).

> release of a hazardous substance at the time of sale or divestiture of the facility or the security interest in the facility.
>
> 3. Fails to obtain a Phase I Environmental Site Assessment of the facility . . . at the time of or at a reasonable time before foreclosure . . . .[31]

Additionally, after acquiring ownership, a lender will lose its exclusion if it fails to do any of the following:

> (a) Provide the department reasonable access so that the necessary remedial actions may be conducted.
>
> (b) Undertake reasonable steps to control access to the area of known presence of a release of a hazardous substance to protect the public health and welfare and the environment.
>
> (c) Act diligently to sell or otherwise divest the property within two years of the lender's possession or ownership, whichever is earlier.[32]

Protections for fiduciaries such as receivers or trustees are also limited under Arizona law as they are under federal law. A fiduciary can be held personally liable if it causes or contributes to a release through its own intentional conduct or gross negligence.[33] Additionally, a fiduciary can be held liable if the appointment of the fiduciary was for the purpose of avoiding liability.[34] If the property is the only substantial asset in the fiduciary estate, it is prima facie evidence that the fiduciary was appointed to avoid liability.[35]

IV. BEST PRACTICES:

A. Fully evaluate property before extending credit

While a lender will be protected from statutory liability if it follows the requirements set forth above, if the collateral is, or becomes, contaminated,

---

31. *Id.*
32. *Id.*
33. ARIZ. REV. STAT. ANN. § 49-283(I) (2014).
34. *Id.*
35. *Id.*

the lender may be faced with the situation where the collateral is worth less than the loan.

The environmental risk evaluation that secured creditors undertake before issuing credit can avoid and minimize future risks associated with direct cleanup liability or devalued collateral. While reviewing a Transaction Screen or a borrower's Phase I Environmental Site Assessment is a useful step, this is just the starting point.

For properties that do not have known contamination, but have or had high-risk or highly regulated uses such as manufacturing plants, industrial facilities, gas stations or dry cleaners, a prudent lender will demand that a prospective borrower evaluate the property's history and ongoing environmental compliance obligations more thoroughly than required by the Phase I standard, which simply establishes the minimum standard for all appropriate inquiry.

B. Consider options to address identified and potential risks

For properties with known contamination, a lender should obtain an evaluation and estimate for cleanup costs, to the extent possible. If the scope of contamination is not fully known, the lender should consider requiring that the borrower investigate, and as necessary, take any actions necessary to remediate the property. To cover the estimated cleanup costs, the lender should insist that the borrower have a defined funding mechanism such as a reserve fund. To address unknown risks, the lender should consider imposing options such as increased equity requirements or environmental insurance, both for the borrower and the lender.

C. Include appropriate contractual terms to reduce the potential for environmental contamination to occur during the term of the loan

For any property, a lender should insist on representations, warranties, and indemnities appropriate for the property at issue. Use restrictions may also be considered. For example, at a retail property, the lender may wish to prohibit certain high-risk retail uses such as gas stations and dry cleaners. A lender may also wish to be informed of any releases, notices of violation or other environmental compliance concerns. Depending on the property's use, periodic notices from the borrower confirming and documenting ongoing compliance may also be appropriate. Ultimately, there are many ways to address known and potential risks contractually. The important takeaway is

to make sure these risks are evaluated and addressed during the drafting process.

V. CONCLUSION

Lenders are afforded significant liability protections under CERCLA, RCRA's UST program, and Arizona's WQARF program. However, these liability exemptions are not unconditional. They impose specific obligations while a loan is active and after foreclosure. Additionally, even if a lender meets the conditions for these exemptions, liability may still attach under other laws and programs. As a result, protecting collateral requires careful and thorough evaluation to understand existing and potential environmental risks as well as precise and thoughtful drafting to minimize those risks to the greatest extent possible.