Potential Clean Water Act Liability Of Foreclosing Lenders

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In October 2006, XYZ Development Partnership broke ground on a 250-unit residential project in Pulaski County. Financing for the project was provided by ABC Bank, which loaned the developer $52,000,000, secured by a mortgage on the property. With home prices steadily increasing, it was a sure thing. By the summer of 2009, both the property and the loan were a mess; only half the houses were completed, dozens were only half-finished, and the borrower had made no interest payment since February of that year. Seeing no light at the end of the tunnel, ABC Bank initiated foreclosure proceedings.

While we created this hypothetical, the basic narrative is being repeated, in one form or another, throughout the United States. As an environmental consultant and an environmental lawyer, we approach situations like this from a narrow perspective: potential environmental liabilities that may be incurred as a result of the lender's foreclosure on the property. Although lenders historically focus on potential exposure under CERCLA, unfinished developments pose a far broader range of environmental liabilities that should be evaluated and addressed in a holistic manner prior to foreclosure. In this article, we discuss one of the environmental statutes implicated by foreclosure: the federal Clean Water Act (CWA).

To oversimplify: the CWA (in Arkansas, the state equivalent to the CWA is the Arkansas Water and Air Pollution Control Act) prohibits the discharge of pollutants (broadly defined as just about anything) into a navigable water unless the discharge complies with a permit issued to the discharger. Unpermitted discharges may be punished by civil or criminal regulatory enforcement action or by civil citizen suit commenced by a non-governmental entity on behalf of the government. Not only are CWA penalties potentially significant – up to $32,500 per day for each violation – but a prevailing citizen suit plaintiff may also seek to recover attorney's fees from the defendant. Although this article focuses on state and federal environmental oversight, we want to emphasize that foreclosing lenders should also be aware of potential regulation by local authorities such as cities and counties.

Almost all substantial construction activities involve excavation, grading, or some other form of earth movement. Once disturbed, soil can be impacted by rain events and become what is referred to as "stormwater runoff." Because stormwater runoff is a CWA "pollutant," its discharge into a navigable water potentially violates the CWA unless the discharge is permitted. Because of the sheer number of construction projects, the EPA and state environmental regulatory agencies (such as the Arkansas Department of Environmental Quality (ADEQ)), have issued general National Pollutant Discharge Elimination System (NPDES) permits governing construction activities (NPDES Construction Permit), which allow a developer to legally discharge stormwater runoff. Accordingly, to avoid CWA exposure, developers must comply with the NPDES Construction Permit.

The CWA presents a potentially daunting problem for foreclosing lenders. In most instances where a developer is facing foreclosure, the measures necessary to ensure continued compliance with the NPDES Construction Permit will have ceased. Runoff normally controlled by what are called "best management practices" (BMPs) will have not only impacted nearby waters, but sediment may also have washed off the property and been deposited onto adjacent parcels. In short, the site will be a disaster. Once foreclosure is complete and the borrower ejected from the property, the obvious target for these litigants is the bank, which now is arguably both the owner and the developer.

A number of states have recognized this potential problem and issued guidance, of one form or another, clarifying their positions regarding lender CWA liability. For example, the State of Georgia NPDES general permits include the statement "In the event a lender or other secured creditor acquires legal title to the facility/construction site, such party must file a new NOI 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." 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." Finally, the State of North Carolina has issued a formal memorandum addressing the "unfortunate" fact that "banks are increasingly taking control of commercial real estate projects of all kinds, many of which are partially completed." While ADEQ does not yet have a formal written policy, it has expressed a willingness to work with foreclosing banks, to the extent possible, to minimize the lender's exposure to CWA liabilities arising from past actions by the borrower.

Over the past few weeks, we have spoken with environmental regulators in many states about this issue. In many cases, they told us that it is their position that foreclosing lenders taking title to a property become the owner and must, in all respects, comply with the applicable provisions of the CWA. That being said that, they have also acknowledged that they would try to avoid unfairly punishing banks dealing with bad loans. When informed about the policies and practices of states like North Carolina and Arkansas, most regulators said they would likely be willing to consider following the lead of such states, albeit on a fact specific, case-by-case basis. If the current pace of foreclosures continues or increases, it would not surprise us if other states eventually adopted their own formal policies in consultation with the regulated community.

All of this raises the obvious question of what measures a lender can take to minimize its potential CWA liability. While every site is unique and must be evaluated individually, we can offer some general suggestions. First, and foremost, the lender should conduct a robust pre-foreclosure environmental due diligence that goes beyond the traditional Phase I Environmental Site Assessment. Results of this investigation should be reviewed by the bank, its environmental consultant, and counsel. Second, the bank should consider whether BMP or other operational CWA violations can be remedied before foreclosure is complete. Of course, in a foreclosure context, the lender may be forced to commit its own resources to undertaking these activities, which is never an easy decision. Third, where problems are identified, the bank should consider initiating contact with the appropriate state and discussing the situation with them. It may even be advisable for the bank to enter into a consent order with the state to memorialize their arrangements and reduce the likelihood of a successful CWA citizen suit. While these steps will not serve as a panacea, they will allow the lender to better understand the environmental landscape and make an informed decision about how to proceed.

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