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CRE Environmental Risk: 12 answers to have before foreclosure

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With the recent increase in property foreclosures, many lenders may be unknowingly assuming significant environmental risk.

While lenders may be shielded from certain environmental liabilities by the secured creditor exemption provided in the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Resource Conservation and Recovery Act (RCRA), the exemption does not apply to other environmental statutes such as the Clean Water Act (CWA) and the Clean Air Act. This leaves lenders exposed to a range of potential environmental liabilities if they foreclose without first conducting adequate environmental inquiry. Given the irrevocability of foreclosure, a lender should undertake a broad range of pre-foreclosure environmental due diligence. Listed below are some of the primary questions a lender should ask as part of its investigation. This list is not intended to be exhaustive and the scope and nature of the inquiry is necessarily fact-specific.

1. Is the property in compliance with all applicable environmental laws?

This is a basic point, but a critical issue. A defaulting borrower often tries to cut costs wherever it can, including costs related to environmental compliance. While the loan documents probably contain representations, warranties, covenants, and indemnities addressing environmental compliance, the value of such provisions is questionable with a defaulting borrower. For this reason, particularly with industrial properties, it is advisable for the lender to engage an environmental consultant pre-foreclosure and obtain a comprehensive environmental picture of the property. It is also a good idea to involve environmental counsel in these initial discussions.

2. Are there ongoing enforcement matters concerning the property?

If such matters exist, the lender should evaluate whether it will be responsible for resolving such matters post-foreclosure. The lender may want to consider meeting with governmental regulators pre-foreclosure to discuss the property and the lender's plans for it. The regulatory agency may view foreclosure as a positive step if the lender is stepping forward to replace an insolvent borrower.

3. Is there a current Phase I Environmental Site Assessment ("Phase I") of the property?

One of the reasons most purchasers require a current Phase I is that they want to qualify for the statutory defenses to CERCLA liability that require a Phase I. While lenders ordinarily are protected from liability by the secured creditor exemption, which does not require a Phase I, it is still a good idea to evaluate the current environmental situation at the property.

4. If there are buildings present on the property, do they contain asbestos-containing materials (ACMs)?

If ACMs are present and people are using the building, the lender may need to ensure that any ACMs (often found in, by way of example, insulation and floor tiles) are maintained in good condition. Ordinarily, this is done through an operations and maintenance (O&M) plan. If the lender has no information whatsoever regarding ACMs in the building, but the structure was built before 1980, the lender should consider undertaking a limited ACM survey to determine whether ACMs are present. Lead-based paint (LBP) may raise similar issues. While it is beyond the scope of this article, it should be noted that a lender who forecloses on certain types of residential properties may be required to provide LBP disclosures to tenants/residents.

5. Is there unfinished construction on the property?

Stormwater runoff that violates the CWA can give rise to significant civil and, in certain cases, criminal liability. If the answer to this question is "yes", the lender will need to assess the situation very carefully. To the extent possible, the lender should refrain from foreclosing on a property where stormwater "best management practices" (BMPs) are not in place. Depending upon the circumstances, it may even be appropriate to contact government regulators pre-foreclosure to discuss the situation.

6. Are there wetlands on the property?

Wetlands are protected under the CWA. Where the property owner has defaulted on its financing, there is a heightened risk that the owner may not be taking the necessary steps to protect wetlands on the property. If there are wetlands and unfinished construction on the property, this issue is particularly important. This same issue exists if there are endangered or threatened species or critical habitat on the property.

7. Are there underground storage tanks (USTs) on the property?

If there are active USTs on the property, the lender may assume ongoing compliance obligations after foreclosure. In certain situations, a lender might also have exposure related to releases from old, abandoned UST's on the property. Certain states have lender liability safe-harbors for UST liability and the lender should coordinate with counsel to make sure it qualifies, where possible, for those safe-harbors. Although this article is primarily aimed at commercial/industrial foreclosures, it is worth nothing that foreclosures on residential properties, particularly in the northeast, can present unique environmental issues related to leaking home heating oil USTs.

8. Have environmental permits been issued for operations on the property?

If so, there may be notice/compliance obligations imposed upon the lender by virtue of the foreclosure. In Georgia, for example, a foreclosing lender must submit a Notice of Intent under Georgia's National Pollutant Discharge Elimination System stormwater permit. Additionally, if a permit is nearing expiration, the lender may be forced to take the lead in filing for a renewal of that permit.

9. Is there pending or threatened environmental litigation related to the property?

Depending upon the nature of such litigation, foreclosure could result in the lender being added as a defendant. In a worst case scenario, foreclosure could even make the lender the primary defendant.

10. Is there ongoing environmental monitoring/remediation at the site?

If so, a foreclosing lender may be obligated to continue such monitoring/remediation post-foreclosure. Needless to say, the cost of such activities can be significant.

11. Is hazardous waste generated or stored at the facility?

If so, the lender may be responsible for dealing with the disposal of such waste post-foreclosure. Improper disposal of hazardous waste can result in environmental liability. However, even proper disposal of hazardous waste can be costly and should be taken into account by the lender.

12. Is the lender aware of any reportable environmental issues?

Depending upon the circumstances, a property owner may be required to report certain issues (such as releases) to governmental authorities. Ordinarily, a lender does not have those obligations. However, a lender should be aware that foreclosure on the property arguably could trigger those obligations.

It is never easy for counsel to raise the issue of environmental due diligence with foreclosing lenders. For a lender dealing with a failed loan, the news that it must now spend additional money on environmental issues is hardly welcome news. Failure to properly assess environmental issues pre-foreclosure can, however, lead to far more significant problems down the road. Accordingly, the investment in pre-foreclosure environmental due diligence is a sound risk-management measure.

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