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Environmental Liability Risk Management

by Joseph Philip Forte

Environmental management is no longer the exclusive preserve of the environmental activist or the conservationist. Congress and the state legislatures have been enacting "superfund", "transfer preclearance", and "superlien" type environmental legislation in response to a perceived need to control the deleterious effect of various contaminants in the environment. The courts have interpreted these environmental statutes to impose strict liability retroactively on innocent landowners for the acts of prior owners or tenants which were neither illegal nor negligent at the time of their occurrence. Consequently, real estate professionals--developers, owners, tenants, and lenders (and their counsel)--have become aware of their potential exposure to liability for toxic waste. The environmental risk is greater than the mere impairment of real estate value occasioned by the non-compliance with ordinary land use statutes.

There are several statutory defenses to liability under the environmental laws (e.g., under federal environmental law--acts of god, acts of war and acts of "non-contractual" third parties), although in practice they provide little comfort to real estate investors. The original federal legislation contained a "security interest" exception upon which many lenders were relying as their insulation from liability. Unfortunately, a federal court has held the exception to be limited to a mortgagee holding indicia of title as a security interest and that it is not available to a mortgagee who has taken the property in foreclosure. In another case, the borrower claimed that the lender by its actions was controlling the owner/operator to the extent that the lender (without holding title) was, in effect, the operator of the facility.

To clarify the noncontractual third party defense the federal environmental legislation was amended in 1986 to provide a new innocent landowner defense which can only be used if the party asserting it can prove that it did not create the problem, exercised due care and had no knowledge or reason to know of the problem. For an investor "[t]o establish that...[it]...had no reason to know" about the hazardous waste an investor "...must

have undertaken, at the time of acquisition, all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice."

It is obvious from escalating governmental environmental activism that there will be no "quick fix" for the problem and that the toxic waste issue has become an integral part of all real estate transactions.

The legislative history of the 1986 amendments indicate that those involved in commercial transactions are to be held to a higher standard of due diligence than parties involved in residential transactions.

Obviously lenders cannot simply cease lending altogether to avoid liability for the risks resulting from contaminated real estate collateral. Lenders must accept existing environmental issues as another risk of doing business and attempt to deal with their potential liability as any other marketplace risk. A lender's best protection will be to train its loan officers to be sensitive to environmental risks which will enable its investment committee to assess the risk and the probability of liability in its underwriting.

The best protection is to train loan officers to be sensitive to environmental risks.

Lenders can best manage their risk by making "appropriate inquiry" into the status of any real estate offered as collateral security for a loan. To conduct sufficient due diligence to assure some measure of knowledge, reasonable inquiry may be appropriate at six distinct phases of a mortgage loan --marketing, underwriting, origination, administration, disposition, and enforcement.

Marketing

While it is continually stated that environmental due diligence must be a case by case approach, a lender can greatly reduce its risks by establishing an institutional lending program. To avoid lost opportunities, the lender should delineate the scope of its lending marketplac--to whom it should lend and upon what types of collateral security. It could determine to avoid companies engaged in making, transporting, storing or dumping toxic substances. The lender, by taking this initial step, eliminates devoting time to potential problem transactions and foregoing other possible lending opportunities. This is simply an allocation of the lender's resources to avoid dedicating time and personnel to transactions that, if prescreened, would not have been financed.

Underwriting

Having determined its lending marketplace, a lender must revise its application forms to include a detailed environmental questionnaire to obtain sufficient information about: the borrower, the borrower's history, and the borrower's business; the location and geography of the property offered as collateral; the proposed uses of the property; and the property's proximity to environmentally sensitive areas (such as farm land, natural waterways, timberland, public water supply

systems and reservoirs, land fill areas, wildlife refuges, and solid waste dumps). An initial site inspection by the loan officer should be performed to determine what he can by visual inspection of the property. The lender should not rely on a third party performing another related function (e.g., appraiser or surveyor) as a substitute for a loan officer actually "walking" the property and adjoining areas.

Regardless of the loan officer's assessment of the proposed collateral, the lender should condition the funding of its loan upon a satisfactory site assessment by a professionally trained environmental engineer or consultant who will evaluate the special risks which may be involved in the structure, soil, ground water or equipment at the property. It may be more prudent for a lender to use an independent environmental consultant rather than a lender employee (even if qualified). This may avoid possible lender liability claims by a borrower that the lender relied solely on the lender's analysis in making its own decision. Any site assessment should include a visual survey (including surface drainage, topography, buildings and water courses), a record review (including the chain of ownership, site use history, historical review of maps, plans, permits and photographs, regulatory history, and insurance and claims), and an area reconnaissance to confirm the status and local context of the property. While this is primarily a paper and visual review, environmental experts contend that the overwhelming majority of problems are identified at this initial phase of investigation.

If after the initial audit there is evidence (or even a suspicion) of contamination, and the investor wishes to continue in the transaction, an environmental consultant must be retained to conduct specific site testing of the structure, soil, groundwater or equipment at the property, as appropriate to prove or disprove contamination. If the property is determined to be contaminated, however, further tests will be necessary to determine the source and extent of the problem. Of course, a written report of assessment and recommendations at each stage should be obtained as a record of the lender's diligence.

It may be prudent to use an independent consultant rather than an employee to avoid possible claims.

Site assessments are both costly and may cause delays and are no guaranty that the property is clean as statistical samples are not foolproof. There have also been instances of "dirty" instruments from prior testing giving bad results to a "clean" property. Moreover "clean" is a question of how sensitive the testing instruments are at a given time, the current wisdom of the scientific community, the perspective of the then government regulators and a variety of other factors. Even an accepted objective standard of what or how much of something is toxic can change over time. Finally, there is always the risk of *new* hazards being "discovered" subsequent to origination of the loan. Nevertheless, any loan commitment should deal expressly with the borrower's obligation to obtain

and pay for an environmental audit and the lender's obligation to fund the loan should be contingent on satisfactory audit results.

Origination

Regardless of a lender's underwriting diligence, the potential risk of a problem continues and should be dealt with at the closing and funding of the mortgage loan. Lenders will want the closing documents to shift the liability (to the extent possible) to the borrower, a third party guarantor or third party service provider.

At a minimum, the loan documents delivered at closing should contain specific provisions dealing with environmental hazards including representations and warranties concerning borrower and tenant use, in compliance with law, no notice received; covenants not to cause problem or suffer environmental liens and an indemnification of the lender for all clean-up costs regardless of borrower's fault. These representations, warranties, covenants and indemnification for environmental risk should be carved out of any exculpation clause in the loan documents. The borrower and/or its principals should have personal liability to the lender for these risks. In fact, if the borrower is not deemed creditworthy for the risk, a personal guaranty by a third party might be obtained.

A breach of any of the foregoing should constitute an event of default entitling the lender to accelerate the loan. While cash collateral or cash equivalents may be tendered to cover a known problem, the issues are how accurate is the cost estimate for clean-up after the risk has been taken and what level of clean-up a governmental agency will require. It is this inability to determine the limits of liability which will probably mitigate against the use of surety bonds to cover the environmental risk.

Title insurance offers little or no protection to the lender because environmental liens are not always filed in the land records and sometimes attach retroactively. In 1984, the American Land Title Association (ALTA) changed its standard policies to except from coverage "[a]ny law, ordinance or governmental regulation relating to environmental protection." The trend among title insurers is to deny requests for specific affirmative coverage endorsements. The 1987 ALTA policy forms clearly exclude environmental risks not in public records on date of policy (although ALTA has promulgated an environmental lien endorsement (Form F.1) for residential properties).

While liability insurers continue to disclaim coverage under traditional comprehensive general liability policies, environmental impairment policies are offered but are limited to claims made during the term of the policy for events occurring during the term or in a specified retroactive period (but only after a comprehensive engineering study of the insured property is conducted by the insurer's consult-

Lenders will want the closing documents to shift the liability to the borrower.

ant). Unfortunately, environmental impairment insurance coverage is probably still not available to an extent to make it a reliable alternative. However, the recent emergence of clean water insurance coverage would portend well for eventual development of environmental insurance if and when the scientific community can properly identify and quantify the risk. In fact, the 1986 federal environmental amendments did contain provisions to encourage potentially liable parties to form risk pools to distribute toxic waste liability among themselves.

Administration

After closing, due diligence should continue to be maintained during the term of the loan. A standard program should be implemented for proper risk management, including periodic site inspections to monitor the condition and use of the property and to detect visible changes. Obtaining and reviewing annual rent rolls for any new tenants in problem businesses might also be useful. If a property is in a problem area, environmental records should be periodically checked much the same as the tax records are reviewed. Transfers of property should be carefully screened to determine a purchaser's business or intended use of the property. Care should be taken in any subsequent loan modifications not to intentionally (or unintentionally by changing material terms) release prior owners who might have been contractually liable for any environmental damages. A court will recognize a release of liability between two parties although it will have no effect on the government's right to proceed against either or both parties for the environmental claim.

Notwithstanding continued vigilance with respect to the status of the property, equipment, and owner and/or tenant uses, a lender should limit its involvement with a borrower to a debtor-creditor relationship. Moreover, certain lender prerogatives in dealing with the borrower's business should be exercised in such a manner as to avoid any suggestion of lender control which might create operator liability. A lender should only consider entering a joint venture or equity participation arrangement with a borrower after a careful review of potential risk of owner status for the lender.

Due diligence should continue to be maintained during the term of the loan . . . including periodic site inspections.

Yet, diligence is futile if a lender is unable to document its efforts satisfactorily at a later date. Thus, an adequate information and recordkeeping system must be an integrated part of any servicing operation. All notes, inspections, reports, surveys, or studies should be memorialized and maintained in a manner allowing retrieval on a property specific basis. To adequately prove the basis for a lender's decisions may be as important as conducting its diligence if a lender desires to limit its potential liability.

LENDER LIABILITY

Disposition

A lender's liability for its diligence will be extended to third parties when it sells a loan (or a whole or partial participation interest on a loan) to an investor, whether during or after origination of the loan. As environmental issues become more significant, investors may be requesting representations and warranties from originators as a condition to their investment.

To reduce its risk of liability, the originating lender should probably deliver to the investor all of the lender's environmental audit records and any testing reports. The investor can make its own decision on the information. If that is not acceptable, any representation or warranty which is given should be severely limited as to the best of the lender's knowledge, and limited to the inquiry actually conducted by lender's agents. The lender should not put itself in the position of becoming the guarantor or surety of any environmental risk to its investor.

Enforcement

Probably at no time in a loan is a lender more at risk for environmental liability than when it is contemplating realizing on its collateral security. Obviously, if the lender were to take a deed in lieu of foreclosure from its borrower in satisfaction of the borrower's debt, the lender would become the owner with all the concomitant risks. However, even when the lender conducts a judicial foreclosure or exercises a statutory power of sale, unless the property is purchased by an unrelated third party, the lender will bid in its judgment and become the owner of the property. The environmental risks of a lender as owner will be direct and measurably greater.

It is therefore imperative that any lender establish a standard procedure for reviewing collateral security before any enforcement of remedies is considered. The lender should review the existing file (including site inspection and lease reports); the loan documents and subsequent modifications; any guarantees and indemnities obtained at closing; the servicing log to determine post closing actions; the current tenants and uses; and any environmental impairment insurance. The lender should also reinspect the site and possibly conduct certain tests (provided the lender may do so without liability under the loan documents and local law). In many states, the lender will not be able to enter the property to do a site assessment without the present consent of a defaulting borrower.

Even if no problem is detected, a receiver should be sought to provide security for the collateral and avoid any intentional introduction of hazardous substances to the property by a vindictive borrower or accidental introduction by a careless operator/tenant. If, after due diligence, a problem is detected and the risk quantified, the lender may determine (after discussion with investors where applicable) to pursue its remedies under the promissory note or any guarantees which may have been delivered at closing rather than to foreclose on the mortgage.

If a participant in a loan participation wants to enforce the loan over the objection of the lead lender after the lead lender's due diligence, the lender should seek to either assign the record holder portion to the participant or obtain a full indemnity for all damages it may sustain from the participant's enforcement of the loan documents.

In the event a lender finds itself the owner of a hazardous waste facility, it should immediately cause the cessation of operations of the facility in an attempt to limit its liability as an operator.

Conclusion

Not every property offered by a borrower as collateral security for a loan will be a toxic waste site and lending officers should not begin to look for toxic waste under every stone. But with 698 hazardous substances recognized by the federal government, toxic waste is a real and substantial danger to a lender's collateral. While the "appropriate inquiry" conducted at each stage will not necessarily be the same for each loan, the degree of diligence should increase if there is a reasonable suspicion of contamination. While each loan will not require the same environmental audit, an audit *should* be conducted for every loan.

Establishing a staged due diligence program will cause delays in underwriting and cancellations of closings for transactions as borrowers resist the precautions that lenders undertake to ascertain their risks. But as all lenders in the marketplace generally adopt similar diligence programs, borrowers will have no alternative but to accept developing environmental audit procedures as another cost of doing business.

The cost and delay of an environmental survey (and possible testing) is relatively small when compared to astronomical (and perpetual) environmental liability it may avoid for the real estate investor. Each investor should perform its own appropriate inquiry to establish the environmental status of a property at each transfer of an interest in such property. Only in that manner can the investor establish for a court or government regulator the status of a particular property and the extent of his knowledge at the particular point in time of the transfer.

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