



# Trends in Lender Liability and Protections for Environmental Matters

---

Ren Hayhurst (Irvine, CA)  
949-223-7125; [rrhayhurst@bryancave.com](mailto:rrhayhurst@bryancave.com)



*A Broader Perspective<sup>SM</sup>*

# Overview of Program Highlights

---

- **"Lender Liability" encompasses a broad spectrum of claims under contract, tort, equitable and statutory theories.**
  - Claims of lender liability are often asserted as defensive strategies by borrowers who are faced with collection or foreclosure actions, *but*
  - They also can be brought as pre-emptive claims to force a negotiated conclusion when a borrower becomes frustrated in its relationship with the lender.
- **Key Elements of Environmental Indemnity Agreements**
  - Essential Parties
  - Growing trend requesting inclusion of "Sunset" provisions
  - Interplay with Environmental Insurance
- **Exercise of Remedies to Protect Lenders**
  - After default, key considerations prior to taking title
  - Avoiding taking title – use of receiver sales or bankruptcy sales
  - Enforcing indemnity protections independent of loan default remedies

# Overview of Lender Liability

---

- **Typical "Lender Liability" claims:**
  - **Tort Claims:**
    - Breach of Fiduciary Duty – Arises When Exercising “Excessive Control”
      - What is “excessive control”
    - Negligent Loan Administration – Ignoring evidence of illegal environmental activities on the property
    - Fraud/Misrepresentation – Assisting in the concealment of environmental conditions in the transfer of property, either by borrower/owner or by lender following foreclosure
  - **Statutory Claims:**
    - Federal and State Environmental Statutes

# Tort Claims

---

- **Breach of Fiduciary Duty**

- The mere existence of a relationship of trust and confidence by itself does not mean that a lender has a fiduciary duty to a borrower or third parties. Generally, something more is required before a fiduciary duty will exist.
- Lender runs the risk of becoming a fiduciary if it obtains “control” over a borrower or the collateral property.
  - Example = “evidence that the lender was involved in the actual day-to-day management and operations of the borrower or that the lender had the ability to compel the borrower to engage in unusual transactions [in regards to the collateral property]” in order for this duty to arise. *See Multifamily Mortgage Trust 1996-1 v. Century Oaks Ltd.*, (administrative monitoring and placing restrictions on additional financing alone do not equate to control).

# Statutory Issues

---

- CERCLA holds “owners or operators” of “facilities” at which there has been a “release” of a “hazardous substance” into the “environment” liable for the costs of environmental cleanup. 42 U.S.C. §§ 9601, et seq.
- CERCLA is a **strict liability** statute and all current and previous “owners or operators” of a facility are potentially liable for environmental cleanup cost unless that owner or operator qualifies under an exemption.
- Under CERCLA, lenders that do not participate in the management of a facility are exempt from liability. In particular, exempt from the definition of “owner or operator.”
  - Thus “a lender that...holds indicia of ownership [of a facility] primarily to [solely or primarily to] protect a security interest” will be exempt from liability.
  - “Lender” is defined as “an insured depository institution” and also includes “any person...that takes or acquires a security interest from a nonaffiliated person.”
  - “Security interest” is defined to 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.”

## Statutory Issues (2)

---

- Under CERCLA, an “owner or operator” does not include a lender that “did not participate in management” of a facility *prior to foreclosure*, notwithstanding that the lender forecloses on the facility; and :
  - (i) after foreclosure, sells, re-leases (in the case of a lease finance transaction), or liquidates the facility, maintains business activities, winds up operations,
  - (ii) undertakes a response action under CERCLA or under the direction of an on-scene coordinator, with respect to the facility, or
  - (iii) takes any other measure to preserve, protect, or prepare the facility prior to sale or disposition, if the person seeks to sell, re-lease (in the case of a lease finance transaction), or otherwise divest the person of the facility at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements.

# Statutory Issues (3)

- A foreclosing lender may qualify for this exemption if it did not “participate in the management” of the facility (i) prior to foreclosure, and (ii) after it forecloses on the facility, it limits its activities at the facility to usual efforts to protect an interest in collateral property.
  - “Participation in management” is defined under CERCLA to mean a lender that actually participates in the management or operational affairs of a facility; and does not include merely having the capacity to influence, or the unexercised right to control, facility operations.
- A lender that holds a security interest shall be considered to participate in management only if, while the borrower is still in possession of the facility encumbered by the security interest, the lender:
  - exercises decision-making control over the environmental compliance related to the facility, such that the person has undertaken responsibility for the hazardous substance handling or disposal practices related to the facility; or
  - exercises control at a level comparable to that of a manager of the facility, such that the person has assumed or manifested responsibility—
    - for the overall management of the 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 facility other than the function of environmental compliance.

# Statutory Issues (4)

---

- The term “participate in management” expressly does not include:
  - holding a security interest or abandoning or releasing a security interest;
  - including in the terms of an extension of credit, or in a contract or security agreement relating to the extension, a covenant, warranty, or other term or condition that relates to environmental compliance;
  - monitoring or enforcing the terms and conditions of the extension of credit or security interest;
  - monitoring or undertaking inspections of the facility;
  - requiring a response action or other lawful means of addressing the release or threatened release of a hazardous substance in connection with the facility prior to, during, or on the expiration of the term of the extension of credit;
  - providing financial or other advice or counseling in an effort to mitigate, prevent, or cure default or diminution in the value of the facility;
  - restructuring, renegotiating, or otherwise agreeing to alter the terms and conditions of the extension of credit or security interest, exercising forbearance;
  - 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
  - conducting a response action under CERCLA or under the direction of an on-scene coordinator.

# Key Elements of Environmental Indemnity Agreements

---

- Essential Parties
  - Typically include both borrower and guarantor(s) as directly obligated parties – this is not a “guaranty” or “surety” agreement
    - For guarantors, be clear on (i) obligations are direct, but (ii) to be complete, incorporate the waivers listed in the guaranty
- Extent of liability
  - All existing conditions and new conditions arising until the borrower ceases to own **and** control the property.
- Rights of lender during loan term
  - Remember, can inspect, require reports and monitor clean-up activities without being liable as an “owner or operator”

## Key Elements (Part 2)

---

- Survival of Indemnity Obligations
  - Survive foreclosure or deed-in-lieu in favor of lender,
  - Transfer of title to third parties
  - Repayment of loan
- In “one-action rule” states (CA, NV, OR, UT, WA, ID)
  - All states permit enforcement of indemnity either prior to or following foreclosure as loan as proper statutory requirements are recited to protect lender from consequences of one-action rule.
- Practical extent of liability –
  - Until loan is repaid = right to require clean-up and compliance with environmental laws and defense costs
  - Following pay off of loan = primarily defense costs

# “Sunset” Provisions

---

- Growing trend requesting inclusion of “Sunset” provisions.
- Purpose = Release indemnitors from liability following expiration of time following loan repayment.
  - Never applicable in a foreclosure scenario or in the event of an environmental condition requiring remediation
- Fully negotiable, but typical elements include:
  - Expiration of fixed time (*e.g.*, 2, 3 or 5 years) following loan repayment with no environmental issues
  - Evidence of clean condition of property – *i.e.*, evidenced by clean Phase 1 or similar report
- Discuss rationale for and against –
  - For = guarantors and borrower seek finite term of indemnity obligations
  - Against = even though main risk is defense costs, these can be considerable and not part of risk allocation with standard bank loan pricing

# Assignment of Existing Indemnity

## Agreements; Environmental Insurance

---

- Existing third party indemnity agreements
  - Typical for property subject to prior environmental remediation
- Always seek assignment of existing indemnity protections
  - Review requirements for assignment
  - Obtain consent and estoppel from third party indemnitor in favor of lender
- Lender may require insurance as supplement to indemnity
- In contrast, borrower may try to replace indemnity with obtaining insurance
  - Not typical for banks to waive indemnity for insurance
  - Instead, banks become loss payees under such policies and often agree to seek recourse under policy prior to enforcing indemnity
  - Important for lender to make certain to obtain tolling or waiver of statutes of limitations, and carefully review such policies to understand their limitations

# Exercise of Remedies

---

- Never include environmental indemnity in the mortgage or deed of trust
  - Risk “satisfaction” of claims following repayment and release or foreclosure
- Distinguish rights to “serial enforcement” of indemnity obligations
  - Preserve rights to enforce indemnity regardless of status of loan (i.e., whether or not loan is in default)
  - Explain in detail “survival provisions” and enforcement of same
- Carefully review and understand state statutory rights for additional protections, such as:
  - Rights to inspect property and require compliance with laws and environmental reports without becoming a “participant in management”
  - Rights to obtain a receiver for environmental protection prior to loan default
- Include both damages and specific performance enforcement provisions

# New Trend in Pursuing Claims for “Secured Guaranties”

---

- **In One-Action Rule States, Such as CA and WA, Borrowers Seeking to Continue the Expansion of Borrower Protections for Guarantors**
  - Well-established that one-action and anti-deficiency protections for borrowers apply to guarantors, despite lack of statutory support for such application
    - Chief protection courts have afforded is the ability of a guarantor to waive these rights where a borrower cannot do so.
  - Borrowers are trying to include claims that any reference to a “guaranty” and/or an “indemnity” in the DOT makes these unsecured agreements subject to one-action type protections to defeat separate enforcement
    - **Three Keys** – (a) remove references to guaranties and indemnities in the secured obligations unless specifically tied to **only** borrower obligations, (b) specifically exclude third party guaranties and indemnities from secured obligations, and (c) specifically recite that third party guaranties and indemnities are unsecured obligations.

[www.bryancave.com](http://www.bryancave.com)