Environmental Issues for Lenders and Equipment Leasing Companies

Buchalter Nemer Teleseminar

Presented by

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Why Environmental Laws Are Important to Lenders

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- Environmental laws expose lenders to liability in excess of the loan amount and the value of the security
- It is a frequent cause of default and litigation
- Environmental issues complicate foreclosures and workouts
- Sophisticated environmental risk management practices are needed to attract quality borrowers, particularly for lenders shifting away from commercial real estate and into C&I lending

Banking Regulations Require Environmental Risk Programs

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- FDIC Statement of Policy 5000
  - Written policies for environmental risk management
  - Structured environmental risk assessment
  - Staff training
  - Designation of senior environmental officer
  - Loan documentation safeguards
  - Pre-foreclosure due diligence
- Other regulators have similar requirements
  - OTS Examination Handbook, Appendix B, Section 210 (for income property lending)
- Regulators do not require “All Appropriate Inquiries” for all loans

Presentation Overview

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- Pre-lending environmental due diligence, alternatives and recent developments
- Pre-foreclosure environmental due diligence
  - SBA Standard Operating Procedure 50 57 (effective March 1, 2013)
- California Diesel Engine Regulations Applicable to Leasing Companies
- Case Studies
  - *U.S. v. Charles Yi,* 704 F.3d 800 (9th Cir. 2013)
    - Using environmental due diligence to see around corners
  - *Hoang v. California Pacific Bank, 2014 Cal. App. Unpub. LEXIS 5230*
    - Avoiding avoidable mistakes
  - *VFC Partners 26, LLC v. Cadlerocks Centennial Drive, LLC* (1st Cir. 2013)
    - The limitations of a standard environmental indemnity agreement

U.S. v. Charles Yi

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- Affirmed four-year sentence for Clean Air Act violations in connection with condo conversion of 200-unit complex in San Fernando Valley
- Yi initially decided not to remove asbestos “popcorn” ceilings because $2,000 per unit was too expensive
- When sales slowed, Yi had day laborers remove 50,000 sf of ACBM
- Lawsuits by investors, State regulators and parent company bankruptcy follow
- Lender’s due diligence used to support a “willfull ignorance” jury instruction
- Phase I and Operation & Maintenance Plan for ACBM in lender’s files
- How could the lender have protected itself from probable catastrophic losses?

Pre-Lending Environmental Due Diligence

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- No "one-size-fits-all" approach
  - SBA (SOP 50 10 5(e) effective March 1, 2009) reflects current industry standard
  - Must show "adequate consideration of EPA's 'All Appropriate Inquiries Rule'" (effective November 1, 2006)
- Determine whether it is appropriate to require borrower to perform AAI
- SBA SOP 50 10 5(e) – Tiered Approach
  - Transaction size and NAICS codes
  - Environmental Questionnaire
  - Records Search with Risk Assessment
  - Transaction Screen
  - Phase I and Phase II ESAs ("All Appropriate Inquiries")

Pre-Lending Environmental Due Diligence – OTS Exam Handbook

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- Risk thresholds
  - Property type and use
  - Loan amount
- Tiered approach
- Address hazardous building materials such as asbestos and lead-based paint
- Criteria for determining when loan normally will be declined
- Incorporation of environmental provisions in:
  - Commitment Letters: extent of due diligence, borrower costs, approval contingencies, etc.
  - Loan documents: reps and warranties, inspections, reporting, freeze lines of credit
- Controls to ensure adherence to safety and soundness principles

Benefits of "All Appropriate Inquiries" Approach

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- Not required for lender protection under CERCLA
- Allows borrower to qualify for Innocent Landowner and Bona Fide Prospective Purchaser Defenses
  - Protects borrower's ability to repay
- AAI reports typically exclude mold, asbestos and lead-based paint

Additional Types of Environmental Due Diligence

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- Property Condition Assessment
  - Fills in gaps in Phase I reports
  - Scope is flexible
  - Especially appropriate for multi-family housing

- Child care and residential care facilities constructed prior to 1980 should undergo lead risk assessment (paint and drinking water) (required for SBA loans)

- Dry cleaners should undergo Phase II (required for SBA loans)

- Gas stations: Phase II requirements dropped by SBA in 2009

Closing Loans with Environmentally Impacted Collateral: Mitigating Factors

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- Contractual indemnification
- Completed remediation or "No Further Action" letter
- De minimus impact on value of collateral
  - Must be verified by environmental professional
- Escrow account
  - Typically 150-200% of clean up costs estimated by environmental professional
  - Lender must not control or manage remediation
- Groundwater contamination originating from another site
  - Solvent RP
  - Verified exemptions under State and Federal Law
- Special covenants and O&M Agreements

U.S. v. Charles Yi
Lessons Learned

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- Lender obtained Phase I
- O&M Agreement required owner to use professionals if ACBMs would be disturbed
  - Would have to be disclosed to individual buyers
- Can lender foreclose and resell condos with asbestos popcorn ceilings?
- Strategies:
  - Require asbestos abatement post-closing
  - Escrow funds for asbestos removal

Pre-Foreclosure Due Diligence

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- SBA SOP 50 57 (effective March 1, 2013)
  - Excellent step-by-step approach
  - Prevents risk of further loan losses
  - Ensures compliance with requirements of secured creditor's exemptions
  - Suitable for adoption by non-SBA lenders

When Environmental Due Diligence is Necessary

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- Acquiring any real property (credit bid at foreclosure, deed-in-lieu)
- Taking over business that uses hazardous substances or sits on contaminated property
- Abandoning or discounting collateral based on unsubstantiated allegations of contamination

Scope of Investigation

- Evaluate value of property, loan balance, activities on property, prior investigations
- High risk: Phase I ESA
- Low risk: Environmental questionnaire or transaction screen
  - Followed by Phase I if questionnaire or transaction screen shows a high risk of contamination
- Out-of-scope environmental inquiries should be conducted if the problem could have a material effect on the recoverable value of the property
- Phase II should be conducted if needed to determine nature and extent of Phase I
  - Should include remediation cost estimate

Obtaining Access for Post-Default Environmental Due Diligence

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- A secured creditor has the right under Civil Code Section 2929.5 to enter and inspect real property to determine the extent and nature of a past, present, or threatened release

- Right to enter may be exercised if:
  - Lender has a reasonable belief that contamination exists *that was not disclosed in writing in connection with the making, renewal or modification of the loan; or*
  - Judicial or non-judicial foreclosure proceedings were commenced

- Absent emergency, lender must give notice

- Lender must reimburse borrower for cost of restoration

- A lender may petition the court for access if criteria are satisfied

- Receiver may be appointed to facilitate access and testing, but not required

Taking Title to Contaminated Property

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- Seldom appropriate if CERCLA liability may apply
  - Prior approval by SBA required
  - Formal approval by Senior Environmental Officer
- Evaluate whether lender's exemptions apply
  - Secured creditor exemption
  - Bona fide prospective purchaser
  - Involuntary acquisition by government entity
- Evaluate potential tort liability
- Risk/Cost/Benefit Analysis

Alternatives to Taking Title

- Release lien for consideration (short sale)
- Sell loan documents
- Additional advances to borrower to fund cleanup
- Receivership

U.S. v. Charles Yi
Lessons Learned

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- No liability under CERCLA
- Potential tort liabilities to future homeowners
  - Can't sell units with O&M Agreement
- Risk/Cost/Benefit
  - Under-funded HOA
  - Above-market assessments reduce unit values
- Receivership would be very expensive
- Borrower not competent to remediate

Hoang v. California Pacific Bank

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- Unpublished appellate decision affirming jury verdict awarding $ 2.3 million in damages to party that purchased contaminated REO from bank
- Bank financed purchase of former dry cleaning solvent packaging plant, which was already contaminated. Borrower defaulted and filed bankruptcy
- Bank obtained title through foreclosure in early-May, then hired an environmental consultant
- Sold property to plaintiff for $1.1 million in late-May 2003, using a standard form contract with an "as-is" clause, having disclosed contamination to buyer
- Bank agreed to fund consultant's work up to $45,000. If additional work was needed to obtain NFA letter, plaintiff would pay half of first $100,000, with all costs in excess being sole responsibility of bank
- In 2012, plaintiff locked out bank's consultant and sued
- Phase 1: court decides that bank agreed to complete remediation in a reasonable time
- Phase 2: jury awards $2.2 million in cleanup costs based on aggressive estimates
- Court of Appeal affirms, finding contract did not limit buyer to reimbursement of actual expenses or specific performance.

Hoang v. California Pacific Bank
Lessons Learned

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- CERCLA Secured Creditor's Exemption of Limited Use
  - Bank could establish that it:
    - Held a deed of trust to secure repayment of money
    - Did not actively participate in management of hazardous substances
    - Made commercially reasonable efforts to sell post-foreclosure
- Standard form contracts often do not cover special situations
    - Bank thought buyer's remedy was limited to specific performance
    - No post-closing access agreement
    - No judicial reference clause
- Risk/Cost/Benefit
    - Pre-lending due diligence showed contamination, loan was made anyway
    - Ignored drycleaner "red flag"
    - No pre-foreclosure due diligence: no way to assess Risk/Cost/Benefit
- Financial institutions should not agree to obtain NFA letters or indemnify others for the cost of remediation to the satisfaction of the regulators

VFC Partners 26, LLC v. Cadlerocks Centennial Drive, LLC

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- Special servicer gets an unpleasant surprise after First Circuit interprets environmental indemnity agreement commonly used in the Commercial Mortgage-Backed Security (CMBS) market
- Loan secured by a mixed-use property, including a daycare. Pre-lending Phase 1 revealed the presence of PCE (drycleaning solvent) below regulatory limits
- Special servicer obtained a new Phase 1 before foreclosing, which also revealed PCE at below regulatory limits
- Receiver appointed at special servicer's request. Receiver's environmental consultant also found PCE below regulatory limits
- District court awarded special servicer amounts it spent on environmental investigation as well as costs paid by Receiver, which were borne by special servicer, and attorney's fees
- Held: special servicer's costs fell outside the scope of indemnity agreement, because they were not liabilities "sought from or asserted against" servicer
- Held: Receiver's expenses fell outside the scope of the indemnity agreement, because they were not costs "required to take necessary precautions to protect against the release of any Hazardous Waste"

- Eventually, a court will read the agreement (any agreement) and construe it against your institution
- There is a general judicial hostility towards imposing on a borrower or guarantor costs associated with preparing REO for sale
- You can take all of the right steps, then litigate yourself into a quagmire
  - 3-day bench trial and appeal over $110,000 of environmental costs

Issues for Leasing Companies

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- Cal/EPA is an umbrella organization comprised of various offices
- Cal/EPA oversees:
  - Air Resources Board
  - Department of Pesticide Regulation
  - Department of Resources Recycling and Recovery
  - Department of Toxic Substance Control
  - Office of Environmental Health Hazard Assessment
  - State Water Resources Control Board (Water Board)
- The Federal Clean Air Act requires the U.S. EPA to set outdoor air quality standards for the nation. It also permits states to adopt additional or more protective air quality standards if needed. California has set standards for pollutants not addressed by federal law and has more stringent standards for particulate matter
- Primary areas of concern for leasing companies are:
  - Diesel-fueled trucks and busses over 14,000 pounds
  - Portable diesel-fueled engines
  - Stationary “gensets”
  - Yard locomotive engines

Issues for Leasing Companies

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- Truck and bus rules
  - Disclosure and record-keeping requirements are imposed on leasing companies
  - Additional disclosure and record-keeping requirements are imposed on dealers
  - Some requirements may be shifted to operator if the lease is for a period of one year or longer, and terms of rental agreement identify operator as being responsible for compliance
- Portable Equipment Registration Program
  - Diesel-fueled portable engines 50 HP and up
  - Diesel-fueled stationary compression engines 50 HP and up, including gensets
  - Engines owned by a rental business must register as such
  - Lessor must report annually on where unit was operated in California, number of hours, etc.
  - Starting 2013, engines must comply with weighted particulate matter emission fleet averages
- Locomotives
  - Under the Federal Clean Air Act, the EPA has sole authority to adopt and enforce interstate locomotive emissions standards
  - Yard locomotives (locomotives that operate 90% of the time in CA) are required to use ultra-low sulfur diesel fuel
  - California emission and reporting requirements may apply to owners and lessors of yard locomotives

When a Bank Should Hire Environmental Counsel

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- Making a loan secured by potentially contaminated property
  - Find and document "mitigation measures" to facilitate closing
- Making an asset-based loan to an environmentally sensitive industry
- If contamination is discovered after loan is funded, or borrower receives regulatory notice
- Develop or improve environmental risk management program
  - Required by FDIC and OTS for all institutions engaged in real estate lending
- Staff training
  - Lender must ensure that risk management program is properly implemented and followed, and that staff has knowledge needed to evaluate environmental concerns
- Prepare leasing forms for trucks, busses and engines operated in California

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Jeffrey B. Kirschenbaum is a Shareholder in the firm's Litigation Practice Group in San Francisco. His statewide practice focuses on real property litigation and disputes involving financial institutions. Mr. Kirschenbaum has substantial experience representing clients in environmental matters; complex leasing disputes; the defense of lender liability claims; inter-creditor disputes; litigation arising out of the purchase, sale and development of real property; fraud claims; eminent domain, and land use matters; bank operations cases; and general commercial litigation. Mr. Kirschenbaum's clients include financial institutions, investors, developers, institutional property owners, commercial landlords and tenants, and luxury retailers.

Mr. Kirschenbaum often represents real estate secured lenders and property owners in connection with environmental matters and complex code enforcement proceedings. He has advocated for clients affected by environmental issues in federal and state courts, and before the California Department of Toxic Substances Control, the State Water Resources Control Boards, local and state Air Resources Boards, Certified Unified Program Agencies and Participating Agencies, and various county Health Departments, Housing Departments and Development Agencies.

Recent Publications and Presentations

- Speaker, "Environmental Issues for Financial Institutions," Financial Institutions Committee of the Business Law Section of the State Bar of California, September 9, 2014, San Francisco, CA
- Ninth Circuit Opinion Highlights Vapor Intrusion Risks and Challenges Faced by Brownfields Developers and Their Lenders ," Buchalter Nemer *Client Alert*, August 2013
- Panelist, "Legal Analysis and Trends in Banking, Business, and Real Estate Transactions," Environmental Bankers Association Semi-Annual Meeting, June 10, 2013
- Panelist, "Recent Developments in Commercial Lending," California Bankers Association, 122nd Annual Convention of Bank Officers and 46th Annual Bank Counsel Seminar, May 3, 2013
- "New EPA Guidance Clarifies Tenants' Defenses," *GlobeSt.com*, January 18, 2013
- "New EPA Guidance Gives Long-Term Tenants Direct Access to the Bona Fide Prospective Purchaser Defense and Greater Protection from Liability for Historical Contamination," Buchalter Nemer *Client Alert*, January 2013
- Panelist, "How Environmental Due Diligence is Changing for Corporate and Real Estate Transactions," Environmental Bankers Association Semi-Annual Meeting, June 11, 2012
- "Environmental Issues for Lenders: Risks, Opportunities and Best Practices," Buchalter Nemer Brown Bag Teleseminar Series, October 24, 2012
- Co-Author, "Dodd-Frank and Bankruptcy Law", *BNA's Bankruptcy Law Reporter*, August 23, 2012; "*Points & Authorities*, Spring 2012
- "Banker Beware: Bank Practices under Increased Scrutiny as Dodd-Frank Implementation Begins," *Points & Authorities*, Winter 2012
- Co-author, "When Is A Trustee's Sale Really "Final"?," Buchalter Nemer *Lender Alert*, September 2011

Mr. Kirschenbaum graduated, *cum laude*, from the University of California, San Diego, and received department honors with High Distinction in History. He earned his J.D. from UC Berkeley School of Law (Boalt Hall) in 1988.

Areas of Practice

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