Lender Liability for Clean Water Compliance

Patrick J. Paul and Christopher P. Colyer

In an anemic economic recovery, banks, mortgage lenders, and other secured creditors continue to foreclose and repossess properties at an elevated rate. Across the nation, construction projects commenced prior to the economic downturn have been abandoned by insolvent developers and foreclosed upon by banks and other secured lenders. Increasingly, foreclosing parties who conducted traditional pre-foreclosure due diligence to ensure against certain environmental unknowns are surprised to learn they are now responsible for unanticipated environmental liabilities and permitting requirements. These liabilities and requirements were previously imposed only upon developers and their contractors and often not contemplated, and thus not identified, by traditional environmental due diligence. In happier economic times, lenders' environmental liability tended to be limited because foreclosed properties could be resold relatively quickly. Further, a spate of provisions in federal and state laws was designed to specifically protect secured parties from incurring environmental liabilities merely because such parties took actions to protect their assets. Typically such provisions acknowledged that a secured party, if it did nothing more than act to protect an asset and if, in essence, its actions neither caused nor contributed to an environmental liability, it should not be held liable. Such protections to secured parties could be prospective in nature, but they tended to involve the existing state of properties and obligations to remediate or manage contaminated properties. These secured party protections tended not to contemplate forward-looking, compliance-type obligations.

Secured lenders should now take heed. The current economy often requires lenders to hold foreclosed property for months or even years, and the risk of exposure to environmental liabilities and permit requirements dramatically increases. If unresolved, these liabilities and permit requirements can expose the foreclosing lender to very costly state and federal environmental enforcement actions, private citizen suits, and criminal prosecution, even when lenders are taking traditional foreclosure actions.

Fortunately for lenders, the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) shields foreclosing lenders and creditors from certain environmental liabilities so long as the lender acts quickly to divest the distressed property or qualifies as an "innocent landowner" as provided in 42 U.S.C. §§ 9601(20)(E) and 9601(35). Similarly, the Resource Conservation and Recovery Act (RCRA) protects lenders from certain environmental liabilities, although the protection is limited to government actions arising from the ownership or operation of underground storage tanks.

These protections, however, are noticeably absent from the requirements of the Clean Water Act (CWA) and, in particular, the stormwater permitting program of the National Pollutant Discharge Elimination System (NPDES) as it relates to construction projects. Without protections similar to those in CERCLA and RCRA, lenders may be subject to costly environmental liability under the CWA or a corresponding state law.

The CWA, 33 U.S.C. § 1251 *et seq*., regulates the discharge of pollutants into waters of the United States by, among other provisions, making it unlawful to discharge a pollutant without first obtaining an NPDES permit. The NPDES program requires various permits for different point source discharges, including stormwater discharges from a construction site.

Although it varies from state to state, the NPDES program for construction activity stormwater permits requires all owners and operators of a construction site or facility to obtain a discharge permit. The U.S. Environmental Protection Agency (EPA), in its construction general permit, defines the term "owner or operator" as the "owner or operator of any 'facility or activity' subject to regulation under the NPDES program." Within this regulatory ambit, EPA further defines the term "operator" as either a party having operational control over construction plans or a party having day-to-day control of project activities necessary to ensure compliance with a Stormwater Pollution Prevention Plan (SWPPP) or other permit. Therefore, EPA or the state or local permit authority ordinarily requires stormwater permits from all property owners and the general contractor for a typical construction or development project. As a condition of this permit, the permittees must conduct monitoring and incorporate Best Management Practices (BMPs) to control and limit stormwater discharges. Failure to comply with these obligations can result in fines, civil suits, and even criminal penalties.

Prior to foreclosure, environmental liability resulting from failure to receive a stormwater permit or comply with its conditions is limited to the various permittees. However, upon foreclosure, EPA and states look to the foreclosing lender as the new owner or operator of the incomplete construction site, which, as a result, requires the lender to obtain a stormwater discharge permit. Therefore, the foreclosing lender becomes subject to any applicable NPDES permit requirements attached to the site and, more importantly, becomes liable for any preexisting and ongoing violations incurred by the previous property owner.

Given the large number of stalled or abandoned construction projects, lenders increasingly are foreclosing on properties having existing environmental liabilities and NPDES permitting obligations. However, despite this looming issue, EPA and a majority of states implementing the NPDES program have failed to address this issue or forewarn lenders of these potential issues. Only until the last few years have a small minority of states begun to expressly address this issue—either through changes in their actual stormwater permit program or through published guidance. As states continue to struggle with substantial budget crises, raising revenue to support environmental protection via stormwater enforcement on lenders and other secured parties may become an increasing reality.

For example, Georgia's stormwater discharge construction permit now explicitly requires foreclosing lenders to file a Notice of Intent within the earlier of thirty days after acquiring legal title to the property or seven days after beginning work at the site. Similarly, Tennessee's proposed construction permit provides explicit instructions to a foreclosing lender. This proposed permit requires a foreclosing lender to obtain permit coverage through a

Published in *Natural Resources & Environment* Volume 25, Number 4, Spring 2011.

Notice of Intent if the construction is inactive but not sufficiently stabilized. The foreclosing lender must then continue to comply with the permit conditions until the lender completely stabilizes the property or transfers the property to a new owner or operator who plans to begin construction activity in the near future. However, if the site is already stabilized, the permit states that permit coverage for the foreclosing party is unnecessary until construction activity resumes.

At least two other states have given general guidance to foreclosing lenders advising them of their NPDES responsibilities. In May 2009, the Minnesota Pollution Control Agency published guidance regarding construction stormwater permits warning lenders with repossessed property under construction that they may be liable for permit noncompliance and environmental damages. In published guidance on abandoned construction sites, California also reminds lenders they are responsible for stabilization of a distressed property under its stormwater regulations upon foreclosure. California also warns that it can place a tax lien on the property or cloud the title.

Given the substantial risk and exposure created, lenders and their counsel must be aware of the issue and be proactive to prevent or mitigate potential fines, claims, and damages. Prior to lending, lenders should account for this potential liability risk by building it into its offered interest-rate calculation. After closing of the loan, but prior to foreclosure, lenders should conduct extensive due diligence, beyond a typical Phase I environmental site assessment, perhaps to include compliance issues to adequately determine the risk that will be incurred through foreclosure. Likewise, the lender should work with the applicable state agency or regional EPA office prior to foreclosure to identify all liabilities arising from the distressed property and to work out strategies to mitigate or preclude future damages. A lender should also attempt to correct all violations or BMP issues prior to foreclosure.

Despite the economy finally showing signs of life, foreclosures of incomplete and abandoned construction projects will undoubtedly continue for the foreseeable future. Given the potential for tremendous exposure to lenders, EPA and various state environmental agencies need to address this and determine if a lender shield similar to that found in CERCLA or RCRA is necessary. Until that point, lenders and counsel need to be alert to the potential for substantial liability resulting from these unforeseen environmental issues.

Mr. Paul is a partner with the Phoenix, Arizona, office of Snell & Wilmer L.L.P. and a member of the editorial board of* Natural Resources & Environment. *He may be reached at ppaul@swlaw.com. Mr. Colyer is an associate with Snell & Wilmer L.L.P. and may be reached at ccolyer@swlaw.com.