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Identifying and Indemnifying Against Environmental Risks

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Abstract. A brief overview of environmental risks affecting mortgage lenders, how mortgage lenders can use environmental indemnity agreements to help protect themselves from those risks, and common issues relating to environmental indemnity agreements entered into in connection with secured lending transactions.

Environmental laws and regulations pose a number of different concerns to mortgage lenders. These concerns involve both direct liability – liability imposed directly upon the lender – and indirect liability – liability imposed indirectly upon the lender due to economic impacts on the loan. Although environmental programs do offer lenders some protections against environmental concerns, often times there can be significant gaps in those offered protections. One of the best and most frequently used devices employed by mortgage lenders to protect themselves from environmental risks is the environmental indemnity agreement. This paper provides an overview of potential environmental liabilities affecting mortgage lenders, followed by an overview of environmental indemnity agreements, including a discussion of common provisions and how those provisions affect both secured mortgage lenders and their borrowers.

I. Overview of Environmental Law

Environmental liabilities created by environmental statutes and the common law take on a number of different forms. These liabilities include costs of compliance, such as capital and operating expenses for required pollution control equipment and the time and expense for acquiring necessary permits, and costs of non-compliance, *i.e.*, administrative, civil, and criminal sanctions, which include fines, injunctive relief, (*e.g.*, to compel compliance or prohibit non-compliant operations), and, for criminal violations, imprisonment. Environmental liabilities also include natural resource damages, which are often substantial, and costs of investigation and remediation. Under the common law, liabilities include those for damages to people --toxic tort--and to property, as well as those attributable to contract claims involving contaminated property. Environmental laws may also result in land use restrictions that may affect the ability to use property for a particular purpose.

A. Regulatory Programs

Environmental laws regulate business activities because of their effects or potential effects on the environment or on human health via the environment. Federal environmental statutes generally fall into three categories: (i) statutes dealing with wastes and their disposition; (ii) statutes dealing with the use of raw materials and the manufacture, importation, and distribution of products; and (iii) statutes dealing with the conservation of natural resources.

The first category of environmental programs deals with wastes and their disposition. These so-called pollution statutes include the Clean Water Act ("CWA"),[1] the Clean Air Act ("CAA"),[2]

[1] 33 U.S.C. §§ 1251 et seq.

the Resource Conservation and Recovery Act ("RCRA"),[3] the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA" or "Superfund"),[4] and the Underground Injection Control ("UIC") program of the Safe Drinking Water Act ("SDWA").[5] Each of these programs is administered by the United States Environmental Protection Agency ("EPA") and, with the exception of CERCLA, may be delegated by EPA to state environmental agencies.

The second category of environmental statutes deals with the use of raw materials and the manufacture, importation, and distribution of products. Statutes falling into this category include the Toxic Substances Control Act ("TSCA"),[6] the Federal Insecticide, Fungicide and Rodenticide Act ("FIFRA"),[7] the Emergency Planning and Community Right-to-Know Act ("EPCRA") of Superfund, as amended by the Superfund Amendments and Reauthorization Act ("SARA"),[8] and the SDWA as it relates to drinking water regulation.[9]

The third category of environmental statutes deals with the conservation of natural resources. These statutes may require review and possibly mitigation of effects of proposed activities based on their potential impact on the environment or various segments of it, including animals and plants. Examples of statutes falling into this category include the National Environmental Policy Act ("NEPA"),[10] the Endangered Species Act ("ESA"),[11] the Wild and Scenic Rivers Act,[12] the Migratory Bird Treaty Act,[13] and the National Historic Preservation Act.[14]

Environmental statutes generally prescribe standards of conduct. The federal pollution statutes, for example, provide for the establishment of technology-based limits on pollutant-emitting activities and for further ratcheting down of those limits if necessary to protect the environment. These statutes also prescribe administrative requirements, such as permitting, monitoring, recordkeeping, and the reporting of routine and emergency releases.

Certain environmental statutes can result in restrictions on land use. For example, the CWA, in section 404, requires permitting as a prerequisite to the placement of dredged or fill materials and, in section 402, the discharge of any pollutants into waters of the United States. After receiving and considering more than 1 million public comments, EPA and the U.S. Army Corps of Engineers published their Clean Water Rule, defining waters of the United States.[15] As another example, the ESA also may prohibit or restrict development if it adversely affects endangered species. Other programs may indirectly restrict land use. Under the CAA, for example, certain types of construction of new sources of air contaminants may be restricted or

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[2] 42 U.S.C. §§ 7401 et seq.
[3] 42 U.S.C. §§ 6901 et seq.
[4] 42 U.S.C. §§ 9601 et seq.
[5] 42 U.S.C. §§ 300h et seq.
[6] 15 U.S.C. §§ 2601 et seq.
[7] 7 U.S.C. §§ 136 et seq.
[8] 42 U.S.C. §§ 11001 et seq.
[9] 42 U.S.C. §§ 300f et seq.
[10] 42 U.S.C.§§ 4321 et seq.
[11] 16 U.S.C.§§ 1531 et seq.
[12] 16 U.S.C.§§ 1271 et seq.
[13] 16 U.S.C. §§ 704 et seq.
[14] 16 U.S.C §§ 470 et seq.
[15] 80 Fed. Reg. 37054 (June 29, 2015).

made more difficult based on the air quality of the region in which the property is located. Similarly, under the CWA, discharges into watercourses may be restricted because of water quality limitations, which affect the uses available for property with wastewater discharge needs.

States may also have their own independent programs that parallel or supplement federal programs. For example, Texas regulates the management of industrial wastes, in addition to hazardous solid wastes regulated under the delegated federal program.

As noted, environmental statutes contain substantial sanctions for non-compliance, which may take the form of administrative, civil, and criminal penalties. Many environmental statutes specifically authorize citizens, as well as governmental agencies, to bring suit to enforce compliance and, in some instances, to abate imminent threats to public health or the environment.

B. Superfund

Because the federal pollution statutes were generally prescriptive in nature and did not deal with problems of the past,[16] Congress enacted Superfund in 1980. Superfund imposes strict and generally joint and several liabilities on so-called potentially responsible parties, or "PRPs," for the cost of investigation and remediation of sites that contain "hazardous substances," as well as for natural resource damages.[17] The term "hazardous substance" is broadly defined to include a range of materials regulated under other environmental statutes, but expressly excludes petroleum, which is addressed by other statutory programs.[18]

PRPs include present owners and operators and certain past owners and operators (*i.e.*, those at the time of disposal) of contaminated properties, as well as those who arranged for disposal of their wastes at such properties and transporters who selected those properties for disposal.[19] In one disturbing case, a federal district court held that an equipment lessor could be liable as well – as a facility owner.[20] Because liability is strict, the fact that a PRP acted in compliance with the law is not a defense. There are Superfund defenses, but they are limited and do not protect against liability under other statutes and the common law.

When Superfund was enacted, it contained three defenses -- act of god, act of war, and act of a third party. Subsequent amendments added others – the innocent land owner defense -- in 1986, and both the bona fide prospective purchaser defense and the contiguous land owner defense -- in 2002. These three defenses require pre-acquisition "all appropriate inquiry," post-acquisition caretaking by complying with specified continuing obligations, and "no affiliation" with a PRP. These three defenses apply only to purchasers (or lessees) of real estate and not to those who acquire stock.

Superfund and other programs relating to on-site conditions may also create de facto and, in some instances, de jure restrictions on land use, *e.g.*, prohibitions on the use of ground water or

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[16] Exceptions include sections 7002 and 7003 of RCRA that authorize suits to address imminent hazards.
[17] 42 U.S.C. § 9607(a).
[18] 42 U.S.C. § 9601(14).
[19] 42 U.S.C. § 9607(a).
[20] *U.S. v. Saporito*, 684 F. Supp.2d 1043 (N.D.IL 2010).

continuing obligations to monitor the quality of ground water. In addition, both federal and state Superfund programs empower the government to impose a lien on remediated sites to secure payment of governmental costs in dealing with the site.

C. Common Law Liabilities

Third party liabilities can arise from common law causes of action, such as nuisance, negligence, and trespass. These liabilities may result in claims for damages to, or diminution in value of, property, as well as for injuries to people. They also can arise from contractual obligations, *e.g.*, for breach of contract or for indemnification, relating to the presence of contamination.

II. Concerns to Lenders

A. Indirect liability

Lenders face potential economic loss as a result of: (1) impairment of the ability of a borrower to repay a loan due to environmental liabilities; (2) diminution in value of collateral because of environmental conditions; and (3) subordination of security interest to an environmental lien.

(1) Ability to repay loan

In assessing the financial viability of a prospective borrower, the lender should investigate the various environmental costs that may affect the ability of the borrower to repay. Costs of compliance, costs of noncompliance, and liabilities associated with on-site and off-site disposal may be significant. In a development situation, restrictions on property use imposed because of the presence of a protected species, the presence of jurisdictional waters or the presence of contamination could result in increased development costs or, in extreme cases, a prohibition on development.

(2) Diminution in value of collateral

The value of real estate used as collateral may be affected by land use restrictions imposed by environmental laws and by liabilities associated with on-site disposal and the on-site conditions, which burden not only the borrower, but the property as well. Environmental restrictions may render a proposed use infeasible. On-site conditions may create substantial liabilities associated with regulatory requirements, cleanup, compensation to the government for damages to natural resources, and toxic tort litigation.

The presence of on-site contamination obviously impairs the value of real estate and possibly of equipment in which those contaminants are stored. Costs of cleanup and of damages to natural resources, people, and property often are significant and in many instances far exceed the value of the property.

(3) Subordination of security interest to an environmental lien

Under Superfund and its Texas analog, the Texas Solid Waste Disposal Act (SWDA), cleanup costs incurred by the government give rise to a lien on the property remediated. Under Superfund and the Texas statute, this lien does not take priority over prior recorded liens. In some other states, however, the environmental lien is a so-called Superlien taking priority over prior recorded liens, including mortgages.

B. Direct liability

(1) Federal law

The potential for direct liability is the most serious concern for lenders. Direct liability is based on the activity of the lender and, unlike indirect liabilities, is not limited by the value of the loan. Although direct liability can arise under any of the environmental laws based on lender involvement (*e.g.*, operators are liable for asbestos demolition or renovation violations) and as a result of common law actions,[21] the focus of industry attention has been on Superfund and its state analogs. The basis for a secured creditor to be liable differs, depending on whether it has foreclosed.

(a) CERCLA

The federal Superfund statute expressly defines the term "owner and operator" as "any person owning or operating [the] facility,"[22] a circular definition that provides no assistance. The definition has an exemption, however, noting that the term "does not include a person, who, without participating in the management of a ... facility, holds *indicia* of ownership primarily to protect his security interest in the ... facility." The purpose of this exemption – the so-called secured creditor exemption – is to ensure that in states in which secured parties hold legal title, those parties are not liable merely by virtue of their holding a legal interest.

In a number of federal secured lender liability cases, courts considered the potential for Superfund liability based on pre- and post-foreclosure actions of the lender. Although some cases found lending institutions that foreclosed liable as owners,[23] the trend was to hold that foreclosure and the taking of prudent and routine steps to secure property against depreciation did not create liability.[24] With regard to pre-foreclosure activities, case law suggested that a lender that actually participated in the managerial and operational aspects of the facility, and specifically those aspects that involve the handling of on-site contaminants, could be liable as an operator.[25] The EPA promulgated rules to clarify the secured creditor exemption, [26] but the rules were invalidated as beyond the scope of agency authority.[27] The EPA, however, re-issued the

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[21] *See O'Neil v. QLCRI, Inc.*, 750 F.Supp. 551 (D.R.I.1990) (court allowing a claim charging a credit union with aiding and abetting the environmental and nuisance law violation of its borrower because the lender knew of a sewage problem and could have conditioned the loans upon compliance with environmental laws). This case settled, but the holding represents a radical expansion of lender liability.
[22] 42 U.S.C. §§ 9601(20)(A), 9601(20)(E)(i).
[23] *Id.*
[24] *United States v. Mirabile*, 15 Envtl.L.Rep. (Envtl.L.Inst.) 20,994, 1985 WL 97 (E.D.Pa.1985).
[25] *See Mirabile*, 15 Envtl.L.Rep. at 20,994.
[26] 57 Fed.Reg. 18344 (April 29, 1992).
[27] *Kelley v. EPA*, 15 F.3d 1100 (D.C.Cir.1994), *rehearing denied*, 25 F.3d 1088 (C.A.D.C.1994).

invalidated rules as a policy statement.[28]

To further address lenders' concerns regarding direct liability, Congress enacted the Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996. This act generally enhanced protection of lenders from Superfund liability as an owner or operator, both pre- and post-foreclosure and established safe harbors. It also established a negligence standard for personal liability of fiduciaries.[29] For mortgage lenders that foreclose, the act clarified that Superfund liability does not attach as long as the lender seeks to sell, release (for lease finance transactions), or otherwise divest itself of the property at the "earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."[30] The exemption does not apply if the property is being held for investment purposes or if the lender engages in activities that would give rise to operator or arranger liability, *e.g.*, it disposes of waste onsite.

The CERCLA protections, however, are predicated upon the lender not having "participated in management of [the facility] prior to foreclosure."[31] "Participation in management" means more that have the 'capacity to influence' or having an 'unexercised right to control' operations.[32] Actions that constitute participation in management include, while the borrower is in possession of the facility, exercising decision making control either over day-to-day environmental compliance or "over all or substantially all of the operational functions (as distinguished from financial or administrative functions) … other than the function of environmental compliance."[33] CERCLA specifically excludes certain acts from participation in management, including holding, abandoning or releasing a security interest; including terms in the loan agreements relating to environmental compliance; monitoring and enforcing the terms of a credit agreement or security interest," inspecting the facility; requiring a remediation by borrower; and providing financial counseling.[34]

(b) RCRA

Under the Resource Conservation and Recovery Act (**"**RCRA**"**), which regulates underground storage tanks or USTs, lenders also had exposure to direct liability. The Asset Conservation, Lender Liability, and Deposit Insurance Protection Act also amended RCRA as it related to underground storage tanks, to provide similar protections, and EPA thereafter adopted an UST lender liability rule,[35] which contains a security interest exemption similar to that under CERCLA.[36]

Under EPA's RCRA rule, a lender is exempt from corrective action requirements and from

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[28] 60 Fed.Reg. 63,517 (Dec. 11, 1995). *See also* "Policy on interpreting CERCLA Provisions Addressing Lenders and Involuntary Acquisitions by Governmental Entities," June 40, 1997 http://www2.epa.gov/sites/production/files/documents/lendr-aquis-mem.pdf (last visited 8/24/2014).
[29] 42 U.S.C.A. §§ 9601(20)(E), 9607(n).
[30] 42.U.S.C. § 9601(20)(E)(ii).
[31] 42 U.S.C. § 9601(20)(E)(ii).
[32] 42 U.S.C. § 9601(20)(E)(i)(II).
[33] 42 U.S.C. § 9601(20)(F)(i).
[34] 42 U.S.C. § 9601(20)(F)(iv).
[35] 40 C.F.R. §§ 280.200 to 280.230.
[36] *See* 42 U.S.C. § 6991b(h)(9).

technical and financial responsibility requirements (*i.e.*, is not considered an "owner" or "operator") as long as the lender:

• holds indicia of ownership (*e.g.*, mortgage, deed of trust, lien, pledge or surety bond) in the UST or on property where the UST is located to protect a security interest;[37]
• does not engage in petroleum production, refining, and marketing;[38] and
• does not participate in the management or operation of the USTs.[39]

The rule sets up a procedure for operating an UST or UST system after foreclosure, which if strictly observed, will insulate the lender from liability. The lender is not considered an "operator" of the UST or UST system if there is an operator, other than the lender, who is in control of or has responsibility for the daily operation of the UST or UST system.[40] If there is not another operator, a lender is still generally not considered an "operator" under the UST rules if the lender: (1) empties all of its known USTs and UST systems within 60 calendar days after foreclosure; and (2) empties any USTs or UST systems that are discovered after foreclosure within 60 calendar days after discovery.[41] The lender must also permanently close the UST or UST system or temporarily close the UST or UST system, provided the lender meets applicable requirements.42 If the lender temporarily closes the UST or UST system, it can remain in temporary closure until a subsequent purchaser has acquired marketable title to the UST or UST system or to the property upon which it is located.[43]

A lender will lose the exemption and be deemed to participate in the management of a UST if it exercises decision-making control over the operational aspects of the UST or exercises control comparable to that of a manager over the borrower's enterprise.[44] The rule also provides examples of "safe harbor" activities that lenders may undertake without being deemed an "owner" or "operator" of an underground tank system, including actions at the inception of the loan primarily to protect the security interest, monitoring or investigating a borrower's operations or the collateral, or requiring compliance with environmental laws.[45]

(2) Texas Law

Texas followed the federal lead by adding state law environmental liability protections[46] for lenders and fiduciaries in House Bill (**"**HB**"**) 2776, effective September 1, 1997. These protections apply to potential liabilities under both the Texas Water Code (other than potential

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[37] 40 C.F.R. § 280.200(d).
[38] 40 C.F.R. § 280.220(c).
[39] 40 C.F.R. § 280.220(a), 280.210.
[40] 40 C.F.R. § 280.230(b)(1).
[41] 40 C.F.R. § 280.230(b)(2).
[42] 40 C.F.R. § 280.230(b)(3).
[43] 40 C.F.R. § 280.230(b)(4).
[44] 40 C.F.R. § 280.210.
[45] 40 C.F.R. § 280.210(b).
[46] Lender Liability protections are codifed at Tex. Health & Safety Code Ann. §§ 361.651 to 361.652 (fiduciaries) and §§ 361.701-.703 (lenders). Lender and fiduciary protective provisions for petroleum storage tank matters were passed in 1991 and are codified at Tex. Water Code Ann. § 26.3514 (lenders) Tex. Water Code Ann. § 26.3515 (fiduciaries).

liability as an owner or operator of a petroleum storage tank) and the Texas Health and Safety Code, which includes the Texas version of Superfund.

Before the 75th Legislature passed HB 2776, there was no secured creditor exemption in the Texas Superfund provisions. HB 2776 added such an exemption and protective provisions for lenders similar to those added to Superfund in 1996. Under that exemption, a lender is generally protected from liability as an owner or operator before foreclosure if it did not "participate in management" of the facility.[47] Participation in management means actual involvement in management as opposed to the unexercised right or capacity to control.[48] More particularly, a lender participates in management if it "exercises decisionmaking control over ... environmental compliance" or if it exercises managerial control over either day-to-day environmental compliance decisionmaking or assumes responsibility for "substantially all of the [non-environmental] operational functions" (such as the control exercised by a plant manager or a chief executive officer).[49]

After foreclosure, to be protected from liability as an owner or operator, a lender must divest itself of the facility "at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."[50] Unlike its federal statutory counterpart, the Texas lender protective provisions include a bright line test or presumption of commercial reasonableness, that is, if a lender lists the facility with a broker or advertises it at least monthly in certain publications within twelve months after foreclosure.[51]

Under the provisions of the Texas Water Code pertaining to tanks,[52] lenders and corporate fiduciaries have some protection from liability. Essentially, the law protects secured lenders[53] that exercise control over property prior to foreclosure, establishing "safe harbor" activities.[54] Activities that a lender may take include, among other things, preserving the collateral or retaining revenues as payment of debt. The lender is not exempt from liability, however, if the lender causes or exacerbates contamination.[55] Foreclosing secured creditors are protected if they remove any tanks from service in accordance with TCEQ rules and complete corrective action in response to any release.

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[47] Tex. Health & Safety Code § 361.702.
[48] Tex. Health & Safety Code § 361.703(a).
[49] Tex. Health & Safety Code §§ 361.703(b), 361.701(5).
[50] Tex. Health & Safety Code § 361.702(a)(2)(B).
[51] Tex. Health & Safety Code § 361.702(b).
[52] Tex. Water Code Ann. §§ 26.341 to 26.367.
[53] The term "lender" is narrowly defined and includes a state or national bank, a state or federal savings and loan association or federal savings bank, a credit union, a state or federal agency that customarily provides financing, and certain entities registered with the Office of Consumer Credit Commissioner. *Id.*, § 26.342.
[54] *Id.*, § 26.3514.
[55] *Id.*, § 26.3514(c).

III. Environmental Indemnity Agreements

A. Overview of Environmental Indemnity Agreements

As noted, secured lenders do have some protections afforded by environmental statutes and implementing regulations, but those protections are not all-encompassing; even a lender that qualifies for all regulatory protections may be exposed to liability. Although parties to a transaction may not preclude governmental enforcement or other third party claims, they may protect themselves from environmental risks through an environmental indemnity provision or agreement. Our focus is on mortgage lenders and their use of environmental indemnity agreements.

An environmental indemnity agreement is an agreement that contains contractual protections for the lender against certain environmental risks and occurrences relating to the property securing the loan. An environmental indemnity agreement generally provides an indemnification from a mortgage borrower and often a guarantor entity to a mortgage lender against any claims, damages, and/or other losses arising from the presence or release of "hazardous substances" at or in connection with the real property that secures the loan.

Although an environmental indemnity agreement is a tool commonly required by lenders to mitigate their lending risk, an environmental indemnity agreement can benefit borrowers as well as lenders. Environmental indemnity agreements that are negotiated prior to the closing of the loan can serve to manage the expectations of all parties involved and clearly set forth the risks and responsibilities of those parties. Additionally, although the negotiation of an environmental indemnity agreement prior to the closing of a loan can add to the structuring costs associated with the transaction, a well thought-out environmental indemnity agreement can minimize the potential risk and future costs of environmental related litigation associated with the property.

A standard environmental indemnity agreement generally contains the following provisions: (i) applicable key environmental related definitions (ii) representations and warranties; (iii) covenants; (iv) the indemnification; (v) cooperation and access provision; and (vi) survival provision. The discussion below briefly addresses these and other pertinent provisions and considerations.

B. Environmental Indemnity Agreements: Important Provisions and General Considerations for Mortgage Borrowers and Lenders

As mentioned above, an environmental indemnity agreement can be a very useful tool for allocating environmental risks and responsibilities with respect to securing a loan to real property. As all real estate lending transactions are different, each environmental indemnity agreement should be carefully crafted for the specific transaction. There are, however, some general considerations that all borrowers and lenders should take into account in negotiating an environmental indemnity agreement.

(1) Who are the Appropriate Parties to the Agreement

An environmental indemnity is generally only as good as the assets that stand behind it. If the indemnitor providing the indemnity has limited assets, then the environmental indemnity might only be worth as much as the paper it is printed on. Today's commercial real estate lending transactions almost always involve borrowers that are "single-purpose entities," typically limited liability companies that hold title to the real estate securing the loan but which have no other assets or liabilities. An environmental indemnity coming from only the mortgage borrower in such a scenario would provide little comfort to a mortgage lender, as such an indemnity would have no assets behind it other than real property containing potential environmental issues. Thus, secured lenders should consider which parties are giving and backing up the environmental indemnity in an environmental indemnity agreement.

Mortgage lenders should generally require that a guarantor entity – typically a parent company with significant assets – co-sign the environmental indemnity agreement along with the mortgage borrower. In the event that the lender needs to assert a claim against the environmental indemnity agreement for indemnification, there then are solid assets backing it up. From a borrower's point of view, this requirement should not really pose an issue since it is generally accepted practice for a lender to require real assets behind any environmental indemnification prior to making a loan secured by real estate. Although particular transactions will differ, secured lenders may be unwilling to make a loan secured by real property if the environmental indemnity only comes from a single-purpose entity borrower.

(2) Key Definitions in Environmental Indemnity Agreements

Environmental indemnity agreements often contain certain key definitions that put the proverbial "meat on the bones" of the environmental indemnification. It is important that secured lenders, borrowers and any guarantors[56] ensure that these key definitions are both clear and unambiguous, to ensure that all parties are obtaining the intended benefits and burdens from the agreement.

Among other things, the parties should also be aware of the potential for circularity among different definitions covered in the agreement (*e.g.*, the definition of "Environmental Laws" containing a reference to "Hazardous Substances" and vice versa). In an effort to make the agreement as clear as possible, circularity should be avoided.

To the extent environmental definitions and other environmental related provisions also are in other loan documents (*e.g.*, in the loan agreement), the parties also should ensure that all those definitions and other provisions do not differ from those in the environmental indemnity agreement because differing definitions and provisions throughout the loan documents will cause confusion and may potentially spawn litigation down the road.

The following are some examples of variations of key definitions that may typically appear in a standard environmental indemnity agreement:

[56] In this discussion, borrower and any guarantor are collectively referred to as "indemnitor".

- Environmental Laws. As with most definitions, it will generally behoove the lender – and be disadvantageous to the indemnitor – to make the definition of "Environmental Laws" as broad as possible. However, the parties may not want to make the definition overly broad so that it causes a default for the indemnitor from the outset of the transaction; such a result benefits neither the indemnitor nor the lender.

  Many environmental indemnity agreements broadly define "Environmental Laws" to include any federal, state and local laws, both present and future, relating to the protection of human health and welfare and the environment. One key consideration is whether the definition of "Environmental Laws" should include the common law. Some lenders choose to include it in the definition so as to expand the definition and thus the scope of the related environmental indemnity. Others choose to exclude the common law from the definition of "Environmental Laws" itself and to only include it in the particular provisions of the environmental indemnity agreement where it is deemed appropriate. This is often a point of negotiation between the indemnitor and the lender. Another consideration is whether the definition should include workplace protection statutes, such as OSHA.

- Hazardous Substances. Once again, it will generally benefit a lender to make the definition of "Hazardous Substances" as broad as possible. However, the same concern remains that none of the parties wants the definition to be so overly broad so as to default the indemnitor on day one of the loan. A common point of negotiation with regards to this definition – one that borrowers typically request – is a limitation as to what is included in the definition of "Hazardous Substances." For instance, a typical limitation that indemnitors request is to exclude substances that would otherwise be included in the definition of "Hazardous Substances" but which are of kinds and in amounts ordinarily and customarily used or stored in properties similar to the property securing the loan conditioned on compliance with environmental laws and other loan documents. The purpose of this limitation is to generally exclude substances used in the everyday cleaning, maintenance, and/or operation of the property securing the loan. An exception, however, is dry cleaners, which historically pose significant environmental risks. Parties to the transaction should address up front whether dry cleaners should be allowed and, if so, under what conditions.

- Indemnified Parties. Although this definition is important for both mortgage lenders and borrowers, it is typically of particular interest to borrowers and guarantors since it sets forth the collective world of who can make claims against them pursuant to the environmental indemnity. Therefore, borrowers and co-signing guarantors generally attempt to narrow this group as much as possible while lenders seek to ensure that all necessary parties are covered, particularly including any of lender's successors and assigns.

  Today's commercial real estate market heavily relies on real estate capital markets and the purchase and sale of commercial real estate backed loans. Thus, lenders want to ensure that their potential successors and assigns are included as "Indemnified Parties" and covered by the environmental indemnity agreement so as to make the loan more desirable to potential purchasers should the lender choose to sell it, particularly if the sale is to a trust for securitization purposes. Having successors and assigns included also is of value if borrower defaults on the loan and the lender has to foreclose on the mortgage and have the property sold at a foreclosure sale.

Indemnitors tend not to like indemnifying unaffiliated third parties that may purchase the property at a foreclosure sale; however, the fact that the indemnity runs to unrelated third-party purchasers increases the value of the property (and most likely the proceeds at the foreclosure sale) and thus increases the chances that lender will be made whole upon the sale of the property.

Although this point is of course subject to negotiation, many secured lenders typically hold firm and argue that they would not have had to foreclose on the property in the first place if the borrower had not defaulted on the loan.

- Losses. This term is a very important because it will determine what exactly the indemnitor will have to indemnify the particular indemnified parties from and against. One common consideration includes whether losses should refer to "any losses," which mortgage lenders clearly prefer, or "losses actually incurred," which indemnitors prefer. Another key consideration is whether the term "Losses" includes only third party claims made against the indemnified parties or if it also includes first party costs and damages incurred by the indemnified parties themselves, *e.g.*, to address onsite contamination that may not be subject to a claim, but that should nonetheless be remediated to protect public health and the environment.

- Release. The definition of "Release" usually refers to any type of release of "Hazardous Substances," including, without limitation, by emission, spillage, escape, and/or disposal. "Release" may also include the migration of "Hazardous Substances." The inclusion of "migration" within the definition of "Release" has been thrust into the spotlight recently due to the higher degree of attention being given to vapor intrusion. Vapor intrusion refers to the possibility that vapors associated with environmental contamination may migrate to the surface and concentrate in buildings at levels that pose health concerns to building occupants. In fact, EPA issued its final guidance on vapor intrusion in June of 2015.[57] As with the other key definitions, how broadly the term "Release" is defined will clearly affect the scope of the indemnity given by the indemnitor to the indemnified parties.

[57] Technical Guide for Assessing And Mitigating the Vapor Intrusion Pathway From Subsurface Vapor Sources to Indoor Air, and Technical Guide For Addressing Petroleum Vapor Intrusion At Leaking Underground Storage Tank Sites; June 2015.

- Remediation. Another key definition that generally appears in most standard environmental indemnity agreements is that of "Remediation." The definition of "Remediation" will usually include any activity to respond to or clean up any "Hazardous Substance" at the real property securing the loan. However, the term can also include any action to comply with "Environmental Laws" or any inspection, investigation, or evaluation relating to any "Hazardous Substances." Once again, this definition is a point of negotiation between the mortgage lender and borrower.

  As is the case with the other key definitions, the borrower would generally like to keep this term as narrow as possible, while the lender would prefer a broader definition to cover more of its bases. However, it is again important to note that it is usually disadvantageous to all parties to have an overly broad definition that might cause a borrower to default on day one of the loan.

(3) Representations, Warranties, and Covenants

a) Representations and Warranties

One way in which secured lenders can get comfortable with potential environmental concerns at the property securing a particular loan is through the use of specific representations and warranties given by the indemnitor in the environmental indemnity agreement. Representations and warranties are contractual protections that the indemnitor gives to the indemnified parties. Although this contractual protection is the primary purpose of the representations and warranties, lenders may also use representations and warranties as a form of due diligence, *i.e.*, to get the borrower to disclose as much as possible regarding environmental matters affecting the property.

Borrowers must be extremely careful in making environmental representations and warranties because a breach of any representation and warranty will generally result in both a default under the loan documents and a trigger of the indemnification provision under the environmental indemnity agreement. Borrowers may attempt to limit their exposure relating to representations and warranties in a number of different ways.

One possible way for a borrower to limit liability is by including deal specific exceptions to the particular representations and warranties. For example, a borrower may include a schedule of known exceptions, as applicable to specific representations and warranties, *i.e.*, indemnitor represents and warrants that there are no hazardous substances in, on, or under the property *except as set forth on schedule 1 attached hereto*. Another way is to except anything disclosed by the Phase I assessment of the property that is performed for the benefit of the lender in connection with the origination of the loan, assuming that the lender has required and obtained such an environmental report, which is typical in secured lending transactions involving real property as the collateral for the loan. Borrower's reasoning for this exception is that the borrower should not have to represent and warrant (and thus expose itself to liability) to any facts that have already been disclosed to lender pursuant to any environmental assessment of the property.

Indemnitors may also attempt to limit liability relating to the representations and warranties they give in an environmental indemnity agreement by adding particular qualifiers to the representations and warranties. The two most common qualifiers that an indemnitor may try to include are a knowledge qualifier and a materiality qualifier. A knowledge qualifier to a particular representation and warranty limits that representation and warranty only to matters known to the indemnitor, *e.g.*, that the indemnitor represents and warrants "*to the best of indemnitor's knowledge*" that there are no hazardous substances in, on, or under the property. A materiality qualifier to a particular representation and warranty limits that representation and warranty only to matters that are material, *e.g.*, there is no past or present non-compliance with environmental laws *in any material respect*.

Although qualifiers such as these are certainly helpful to the indemnitor, one additional consideration that should be made is whether the qualifiers themselves are defined in the agreement, *i.e.*, what does it mean to be "to the best of indemnitor's knowledge" or to be "material." Negotiating the precise meaning of these qualifiers prior to closing can potentially limit future litigation between the parties, as well as provide the parties with a much better understanding of the representations and warranties they are either giving or receiving.

The following are some examples of key representations and warranties that a lender may require in a standard environmental indemnity agreement:

- <u>Compliance with Environmental Laws</u>. From a lender's perspective, a representation and warranty stating that the property is in compliance with all environmental laws is quite helpful. From a borrower's perspective, this particular representation and warranty is one that the borrower would likely try to limit using both a knowledge qualifier and a materiality qualifier. Regardless, it is again important to highlight that liability under Superfund can arise independent of any violation of environmental laws.[58] Therefore, it is important for a lender to understand that the presence of contamination on the property that might trigger liability under Superfund might not actually trigger a breach of this particular representation and warranty. In addition to a representation and warranty regarding current compliance with environmental laws, lenders will typically also require a representation and warranty that there has been no past non-compliance with environmental laws.

- <u>No Hazardous Substances or Underground Storage Tanks In, On, or Under the Property</u>. This representation and warranty may be of particular importance to lenders based on the fact that the representation and warranty given by borrower that the property is in compliance with environmental laws does not necessarily address potential liability under Superfund, related statutes, or the common law regarding on-site contamination. It is important to note that adding a qualifier to this representation – such as "other than those in compliance in all material respects with environmental laws" – guts this representation and warranty from the lender's prospective, *i.e.*, there could be a hazardous substance on the property that is in compliance with environmental laws, therefore making the representation and warranty true, but leaving the lender open to potential liability under Superfund.

[58] 42 U.S.C.A. § 9607.

- No Past or Present Releases of Hazardous Substances In, On, Under, or From the Property. This representation and warranty may overlap with the "no hazardous substance representation," but would also cover offsite contamination that might be migrating toward the property but that is not yet on it.

- Notice of Environmental Issues or Related Litigation. It is beneficial for the lender to have a representation and warranty from the borrower stating that there is no existing or threatened notice of hazardous substances at the property or environmental related litigation. A lender may even request that the representation and warranty go a bit further by stating that the borrower is not aware of any facts that would give rise to any such notices and litigation.

b) Covenants

Although representations and warranties help the lender to understand what it is getting with regards to a particular property, it is the covenants in an environmental indemnity agreement that give the lender comfort on a going forward basis following the closing of the loan. Covenants are promises, made by the indemnitor to the lender, to perform or refrain from performing a specific action. The following are some examples of key covenants that a lender may require in a standard environmental indemnity agreement:

- Compliance with Environmental Laws. A covenant stating that the borrower will comply with all environmental laws, which implicitly would subsume compliance with permits, is a must for any lender with an ongoing relationship with both a borrower and the property securing the loan. A borrower will typically want to add a materiality qualifier to this covenant to ensure it will not be in breach for any minor compliance-related slip up.

- No Release of Hazardous Substances/No Use of Hazardous Substances. This covenant is a no brainer for any lender originating a loan secured by real property. Lenders will almost always require a covenant stating that borrower will not cause or permit any release of hazardous substances at the property. Lenders should generally not permit any qualifiers to this covenant because this is the primary covenant ensuring borrower keeps the real property collateral in good condition and free of detrimental environmental contamination. Additionally, a secured lender would be wise to include a covenant stating that borrower will not keep or use, or permit to be used or kept, any hazardous substances at the property, the theory of course being that, if hazardous substances are not ever located at the property, the likelihood of a release occurring significantly drops. Such a covenant, however, must be reasonable in scope and not preclude, for example, cars with gasoline coming on to the property. This concern can be addressed by the carve out in the definition of Hazardous Substances noted above for materials ordinarily and customarily used or stored on the property.

- No Liens or Encumbrances. Secured lenders will usually require a covenant from borrower stating that borrower will keep the property free and clear of all liens and other encumbrances imposed pursuant to any environmental laws. This covenant becomes even more important for lenders if the loan is secured by real property in a state where such an environmental lien might take priority over prior recorded liens.

- Cooperation. It is important for a secured lender to require a covenant that the borrower will cooperate in all environmentally related matters with respect to the property. Although not absolutely necessary, it is helpful for a lender to have express authorization from the borrower to contact environmental agencies in conjunction with any environmental issue discovered at the property. A point of negotiation between a borrower and lender is often whether borrower cooperation will be at the expense of the borrower or the lender. Lenders often require any borrower cooperation to be at borrower's sole cost and expense.

- Access. In a similar fashion to requiring cooperation, lenders generally require some form of access to borrower's files and to the property. Proper due diligence and an adequate investigation clearly require the lender having access to necessary documents of the borrower, as well as to all parts of the property that will secure the loan. As discussed below, Lenders must have access during the term of the loan, to ensure compliance with the terms of the agreement and prior to any potential foreclosure, to be sure it is not acquiring a liability rather than an asset.

(4) Scope of the Indemnity and the Resulting Indemnity Obligations

One of the main considerations to be made by both mortgage borrowers and lenders in connection with negotiating environmental indemnity agreements is what the intended scope of the indemnity is. An indemnity usually has three basic parts: the trigger, the scope, and the resulting indemnity obligation.

An indemnity may be triggered by any breach in the agreement, including a breach of a representation, warranty or covenant, or by the discovery of an environmental condition or a liability relating to the property. The scope and resulting obligation of an environmental indemnity are typically highly negotiated points between the borrower and lender. Both parties must consider how they are intending to allocate environmental risk using the indemnity agreement. Borrowers and lenders alike should carefully consider whether the language used in the environmental indemnity agreement accurately evidences the desired scope for such indemnity. Both parties should think of real examples they intend to be either covered or not covered, and ensure the language fits those scenarios in order to adequately manage the expectations of both parties. Even with this in mind, determining the scope of an environmental indemnity based on the language crafted in the agreement can often still prove to be a challenge. Thankfully, in analyzing a few common environmental indemnity agreement provisions that often affect the scope of the indemnity, some courts have provided guidance as to the general scope of typical environmental indemnity language. This guidance highlights some key considerations for both mortgage lenders and borrowers regarding the scope of environmental indemnity agreements.

In VFC Partners 26, LLC v. Cadlerocks Centennial Drive, LLC, the First Circuit Court of Appeals analyzed certain indemnification provisions in connection with a claim made by a lender under an environmental indemnity agreement. VCF Partners involved a dispute between a borrower and a lender over environmental related expenses associated with real property following the default by borrower on the loan secured by the property. In VCF Partners, the defendant defaulted on the loan and offered a deed-in-lieu of foreclosure in settlement of the then – current lender's claims prior to foreclosure.[59]

As part of the lender's routine due diligence, lender engaged an environmental consulting company to conduct an updated Phase I test, which revealed the possible presence of hazardous substances on the property. Subsequently, lender ordered a Phase II test of the property.[60] Since this Phase II test identified the presence of hazardous substances in the soil outside the building on the real property, multiple further tests were authorized and performed. There was no further testing until a prospective purchaser insisted on updated results.

A new round of tests was conducted, none of which appeared to have revealed any hazardous level of any hazardous substances. Subsequently, lender sued defendant for reimbursement of costs pursuant to, among other things, the environmental indemnity agreement executed in connection with the loan.[61]

The environmental indemnity agreement in VCF Partners provided in part that defendants would indemnify the applicable indemnitees " 'from and against all ... costs, ... demands, ... expenses' and other liabilities 'of any kind or nature whatsoever ... sought from or asserted against Indemnitees in connection with, in whole or in part, directly or indirectly, ... the presence, suspected presence, release, suspected release, or threat of release of any Hazardous Material' on or around the Property[,]" and further specified that " '[s]uch Liabilities shall include'… 'the cost required to take necessary precautions to protect against the release of any Hazardous Materials in, on, or under the Property, the air, any ground water, waterway or body of water, any public domain or any surrounding areas to the Property.'"[62]

The dispute and the First Circuit's analysis predominantly revolved around the scope of the indemnification language in the environmental indemnity agreement. First, the First Circuit interpreted the language " 'sought from or asserted against' the Indemnitees" to require the existence of a third party imposing some type of liability on the indemnitee and not from any costs incurred on the indemnitee's own behalf.[63] The court's analysis provides an important lesson for both mortgage borrowers and lenders regarding the scope of indemnification language, *i.e.*, that courts will interpret standard environmental indemnity agreements with similar provisions to cover only third party claims against the lender and not first party costs, damages, or losses incurred by the lender itself.

In the wake of this case, a lender will not want indemnity language to be limited to the indemnification of costs or liabilities "sought from or asserted against" the indemnitee since this

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[59] VFC Partners 26, LLC v. Cadlerocks Centennial Drive, LLC, 735 F.3d 25, 26-27 (1st Cir.2013).
[60] Id. at 27.
[61] Id. at 28-29.
[62] Id. at 28-29.
[63] Id. at 30.

limitation can clearly be interpreted to preclude coverage of any expenses incurred by the lender on its own behalf. Lenders should consider including language to make clear that first party costs incurred by lender or on its behalf are also included in the scope of the indemnity, *e.g.*, "sought from or asserted against *or incurred by*…". Borrowers should clearly seek to exclude this additional language so as to limit their exposure only to third party costs asserted against the lender.

The First Circuit also limited the scope of the environmental indemnity by finding that the phrase "'Such Liabilities shall include…'" was a limitation on the preceding liability sentence rather than an example of a non-exclusive list. Therefore, the expenses must fall within the enumerated categories of liability listed in the limitation sentence.[64] Again, this is a lesson to all borrowers and lenders that courts may choose to narrowly interpret the scope of indemnification language in an environmental indemnity agreement.

The court did suggest that, if a party wished to make such a list a non-exclusive list, the inclusion of non-limiting language would weigh in their favor. The court gave examples such as "without limiting the foregoing" or "shall include but not be limited to."[65] Lenders should note this court's decision relating to the limiting language and should consider using the suggested broadening language in order to ensure that any such list in their particular environmental indemnity agreements is not an exclusive one. Once again, borrowers would be wise to mimic the language in the VFC Partners case in order to limit their liability under the environmental indemnity agreement.

(5) Duration of the Indemnity and Sunset Provisions

Another key consideration regarding environmental indemnity agreements is the duration of the indemnity provided by the indemnitor. Obviously, from a borrower's perspective, the shorter the indemnity lasts, the better; conversely, secured lenders would clearly like the indemnity to last as long as possible. Environmental indemnities typically survive repayment of the loan, assignment of the loan, foreclosure of the mortgage securing the loan, and delivery of a deed-in-lieu of foreclosure of the mortgage securing the loan. However, how long the indemnity survives after repayment of the loan is subject to negotiation between the borrower and the lender.

Sunset provisions can be used by mortgage borrowers to limit the duration of their environmental indemnities and to limit their environmental exposure thereunder. A sunset provision is a clause that provides that the borrower's indemnification obligations under the environmental indemnity agreement will expire on a particular future date. A typical sunset provision will state that borrower's indemnification obligations under the environmental indemnity agreement will terminate "x" number of years after the full repayment of the loan in accordance with the terms of the loan documents. The duration of time is subject to negotiation, but the typical duration is between one and five years after the full repayment of the loan.

[64] Id. at 30-31.
[65] Id. at 31.

Although many lenders will permit a certain sunset period for borrower's environmental indemnification obligations, there are usually certain conditions to doing so. Lenders will typically require that there have been no environmental issues with respect to the property for the duration of the sunset term. Additionally, a lender may always require the borrower to provide at the time of such loan repayment an updated Phase I environmental assessment report disclosing no actual or threatened (i) non-compliance with or violation of environmental laws, (ii) environmental liens encumbering the property, (iii) litigation or proceedings concerning any environmental matter, and (iv) presence or release of hazardous substances in, on, or under the property. A phase I typically addresses any recognized environmental conditions and its scope then will need to be expanded to include compliance.

Sunset provisions are generally not applicable in a situation involving a foreclosure of the mortgage by a lender or a deed-in-lieu thereof. However, in the case of a foreclosure or a deed-in-lieu thereof, borrowers can still attempt to negotiate a limit on their environmental indemnification obligations. Borrowers may generally attempt to do this with a provision stating that borrower will not be obligated to indemnify lender for any event or condition first arising after the lender (or its transferee) acquires title to or control of the property or for any event or condition that arises due to lender's willful misconduct or gross negligence. The thresholds of "willful misconduct" and "gross negligence" are often also themselves subject to negotiation. The theory behind these limitations is that the borrower does not want to be responsible for events or conditions that are out of its control and caused by the lender after borrower is no longer involved in the operation of the property. Although many lenders seem amenable to including these limitations in their standard environmental indemnity agreements, lenders are still wary that there may be existing, but unknown, environmental conditions at the property.

(6) Borrower Cooperation, Lender's Access Rights, and Lender's Ability to Investigate and Remediate

As noted, other key interrelated issues pertaining to environmental indemnity agreements include (i) mortgage lender's access rights with regards to the property, (ii) mortgage lender's ability to investigate and remediate environmental conditions with regards to the property, and (iii) borrower's obligation to cooperate with lender regarding these matters. In certain situations, lenders require investigation rights with regards to the property; however, borrowers generally desire to be permitted to own and operate the property uninterrupted so long as borrower is not in default on the loan. Borrowers tend to be concerned with meddlesome lenders that not only potentially interfere with the day to day operation of the property but also incur unnecessary investigation costs that the borrower must typically bear.

It is typical for lenders to require access rights to the property in the event that lender has grounds to believe that an environmental hazard exists on the property that could potentially endanger occupants on the property or adversely affect the value of the property. If lenders do in fact require these access rights, borrowers will often attempt to negotiate both a reasonableness qualifier, *i.e.*, lender has *reasonable grounds* to believe an environmental hazard exists, and a materiality qualifier, *i.e.*, that the potential environmental hazard will *materially adversely affect* the value of the property. Additionally, a borrower will almost always require advanced notice from the lender and that the lender only enter upon the property at reasonable times and subject to the rights of any tenants at the property.

Rather than requiring immediate access for the lender itself, some environmental indemnity agreements provide that, upon notice from the lender regarding its belief that an environmental hazard exists on the property, borrower will cause, at its sole cost and expense (of course, this is open to negotiation), an environmental professional to conduct an environmental assessment of the property. Secured lenders will generally require consent rights over the environmental professional used, as well as the right to determine the necessary scope of the environmental assessment. Depending on the severity of the environmental issue that lender believes to be in existence at the property, lender may require sampling of soil, water, air or other building materials, or any other invasive testing that lender believes to be required. In addition, borrowers typically also expressly agree to cooperate with lender with regards to any such testing and/or access to the property.

In the event that remediation of the property is required, lenders will again require borrower's full cooperation. Additionally, if communication with any governmental or regulatory body is required in connection with the remediation of the property, a lender will typically require notice of any correspondence between any such governmental or regulatory body and the borrower. In fact, some lenders may require that they lead any such remediation efforts and that they be the main point of contact for the applicable governmental or regulatory body.

(7) Environmental Insurance and Environmental Indemnity Agreements

The use of environmental insurance policies has become more common in connection with today's real estate lending transactions. Many lenders typically require that their borrowers maintain environmental insurance policies (*e.g.*, a pollution legal liability environmental insurance policy) in connection with the subject properties. Points of negotiation between a borrower and a lender with respect to an environmental insurance policy can include the rating of the insurance carrier, the policy limits, and what coverage is actually afforded by the policy, *e.g.*, coverage for known and unknown conditions, and/or existing and pre-existing conditions. Additionally, a lender will typically require consent rights over any amendments to the required policies, as well as the lender itself being names as an additional insured on the policy.

Typically the requirement that a borrower obtain an environmental insurance policy will be in addition to the requirement that the borrower provides an environmental indemnity agreement, but in some instances lenders may allow borrowers to substitute insurance for an indemnity. One common issue is how the environmental insurance policy and the environmental indemnity agreement interact with one another. Often times a borrower will request that its liability pursuant to the environmental indemnity agreement will be limited only be to those losses not covered by the environmental insurance policy. Although lenders may be amenable to this compromise as long as they obtain coverage for their losses within a certain specified period of time, it is nonetheless more often than not subject to intense negotiation.

IV. Conclusion

Lenders making loans secured by real property may face a number of environmental concerns. These concerns involve the potential for both direct liability – liability imposed directly upon the lender – and indirect liability – liability imposed indirectly upon the lender due to economic impacts on the loan. Environmental indemnity agreements can help both borrowers and lenders to address these concerns.