

Commentary

Lender's Right to Waive Its Real Property Security Interest in Environmentally Impaired Property

by Paul S. Rutter, Esq.

Executive Summary

Until recently, California law generally required all lenders with real property security, even those with environmentally impaired security, to use foreclosure as their sole remedy in the event of a default. This posed a substantial risk for lenders with environmentally impaired real property collateral because under certain federal laws, a lender who forecloses on such property may be held liable for the environmental remediation for the property. A recently enacted California statute gives lenders the option of waiving their real property security interest in environmentally impaired property and pursuing the borrower directly on the debt; thereby avoiding potential liability for the remediation of environmental contamination of the property.

One Form of Action Rule

Generally, in California, if a borrower is in default under a loan secured by real property, California Code of Civil Procedure ("CCP") §726, the so-called "one form of action rule", makes foreclosure the lender's sole remedy. This rule places the lender in a precarious position if the real property is environmentally contaminated property, as the lender may be exposed to liability under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA") by becoming the owner of the property after foreclosure.¹ Under CCP §726.5, enacted in 1991, under limited circumstances, lenders have the option of waiving their security interest in environmentally impaired property and pursuing the borrower directly for liability on the debt.

Waiver for Environmentally Impaired Property

Under the conditions described below, Section 726.5 allows a lender with a security interest in "environmentally impaired" property or an "affected parcel", which was impaired without the lender's knowledge or complicity, to waive its lien against the property and exercise the rights and remedies of an unsecured creditor against the borrower, provided that the loan is made, renewed or modified on or after January 1, 1992 and before January 1, 2000.² Section 726.5 generally applies to "environmentally impaired" real property which is not used for residential purposes unless the improvements consist of more than fifteen (15) dwelling units.³ It also applies to "affected parcels" of "environmentally impaired" property, that is, portions of such property which are contiguous to the encumbered, impaired property, even if separated by roads, streets, utility easements or railroad rights of way.⁴

Definition of "Environmentally Impaired"

"Environmentally Impaired" property means that the subject property must sustain a release or threatened release of "hazardous substances" which was not disclosed to or known by the lender before the loan was made. Additionally the clean-up or remediation of such hazardous substances must exceed 25% of the fair market value of all of the security given for the loan. For purposes of Section 726.5, the fair market value of the property is the higher of (1) the fair market value of the property at the time the loan was made, or (2) the fair market value of the property at the time of the discovery or the release or threatened

¹ 42 USC §9601 (20)(A).

² CCP § 726.5 (a), 8 and (g).

³ CCP § 726.5 (e)(5).

⁴ CCP § 726.5 (e)(1).

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release for the hazardous substances; in each case, such value is to be determined without regard to the release or threatened release of hazardous substances.⁵ Note that a lender using the option of Section 726.5 must establish in a court proceeding that the property qualifies as “environmentally impaired” under the statutes (although that court action can be combined with a suit for recovery of a debt and the lien will not be waived until the court makes its determination that Section 726.5 applies).

Innocent Borrower Exception

The option of a lender under Section 726.5 to waive its security in property is not available if the so-called “innocent borrower exception” applies. For this exception to apply, (1) neither the borrower, any related party of the borrower, or their respective agents knowingly or negligently caused or contributed to the actual or threatened release of hazardous substances on the property and (2) in connection with a loan origination, renewal or modification, neither the borrower, any related party of the borrower, or their respective agents knew of the release or threatened release, or if such party knew or had notice of the release or threatened release, such party must have disclosed such information. To the lender after the lender’s request for such information, unless the lender otherwise obtained actual knowledge of the release or threatened release prior to making, renewing or modifying the loan.⁶

Additional Collateral Security

If the lender holds additional collateral security for a loan which encumbers environmentally impaired real property, the lender will have to comply with Section 726 as to the foreclosure of its lien on such other property (assuming it is not an “affected parcel”). This somewhat limits lenders’ willingness to take advantage of Section 726.5, since the foreclosure on the additional collateral security would have to be a judicial action in order to avoid the bar of CCP Section 580(d)(barring a deficiency action by the lender following a non-judicial foreclosure)

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⁵ Environmentally impaired properties are also those properties which appear on the National Priorities List pursuant to 42 U.S.C. 9605 or any list published by the California Department of Health Services pursuant to Health and Safety Code § 25356(b). CCP § 726.5 (e)(3).

⁶ CCP § 726.5(d).