Commentary
Part 2 of 2

Other Lender Protections besides Waiver of Security Interest in Contaminated Real Property

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The preceding Commentary focuses on the statutory right of a lender to waive its security interest in environmentally impaired real property under California Code of Civil Procedure Section 726.5. There are, however, additional rights and protections available that may affect a lender's decision whether to waive the security interest and otherwise how to handle an environmental impairment situation. For instance:

Environmental Provisions in Secured Loan Documents. With certain exceptions, Code of Civil Procedure Section 736 allows for the enforcement of environmental provisions in real estate secured loan documents without triggering the debtor protection laws (the one-action rule and the anti-deficiency law). The rationale for environmental provisions is that environmental liability is potentially not limited by the value of the real estate security or the amount of the loan, and therefore a lender should be free to enforce environmental provisions against the borrower without the debtor protections that apply to the loan itself. Section 736 adopts that rationale and provides such relief to lenders, within the framework of the limitations set forth in that section. Enforcement of environmental provisions in the secured loan documents could provide a suitable remedy to a lender, at least where the debtor is able to perform.

Separate Unsecured Environmental Indemnities. It has become standard (although not universal) practice for lenders to require, in addition to environmental provisions in a loan agreement and deed of trust, a separate environmental indemnity agreement that provides direct recourse to a borrower or guarantor, apparently side-stepping the real estate security and debtor protection issue. Such indemnities are usually unsecured or not secured by the same property that secures the loan.

However, there is an open question regarding the enforceability of separate, unsecured environmental indemnities. The question is whether Section 736 defines the limit of the lender relief and precludes unsecured environmental indemnities that are more expansive than the lender relief provided by Section 736 or, at least, precludes enforcement of the more expansive portions of an unsecured indemnity while allowing enforcement of the portions consistent with Section 736.

There is an old California Supreme Court case overruling a device where a lender got both a secured note and an unsecured note for the same debt; the Court had no difficulty disregarding the unsecured note. The same could be the case where a lender has obtained environmental provisions in a loan agreement and deed of trust and also in a separate unsecured indemnity agreement for the same loan.

In addition, Section 736(f) defines "environmental provision" very broadly, including "any written representation, warranty, indemnity, promise or covenant" relating to any hazardous substance concerning the property "whether or not…contained in or secured by the deed of trust or mortgage." Arguably, this covers separate, unsecured environmental indemnities so that they too are enforceable under Section 736 but are likewise limited by its parameters.

For instance, Section 736(a) does not allow enforcement of environmental provisions after the secured obligation has been fully satisfied (which could be after payment or nonjudicial foreclosure) or after the borrower's interest in the property has been transferred to an unaffiliated third party for fair value. Section 736(b) does not allow recovery of damages under an indemnity claim where, among other circumstances, the borrower did not knowingly or negligently cause or contribute to the hazardous substance release and, if the borrower knew of it, the borrower disclosed it when the loan was made, renewed or modified (in effect an innocent borrower defense to enforcement). Environmental indemnities typically have no such limitations and it is therefore not a trivial question whether those limitations apply notwithstanding a more broadly drafted indemnity.

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One would think that – in the 20 years since these devices became widespread, including a couple of real estate downturns – this enforceability issue might have been litigated and resolved.

At any rate, the general enforceability of environmental provisions under Section 736 may be one of the reasons why the lien waiver right under Section 726.5 seems to be little used. An additional reason may be the preliminary requirement under Section 726.5(b) that the lender first establish by way of a court order that the property is "environmentally impaired" as defined by Section 726.5(e)(3), which would entail delay and expense that may not be worth it as compared to bringing an enforcement action under Section 736.

Environmental Guaranties. In real property secured financings, lenders often require the delivery of a guaranty of payment and performance, including environmental provisions. Such guaranties might be unsecured or secured by property other than the real estate security for the loan. Most lenders will conclude that it makes sense to bring an action not just against the borrower under Sections 726.5 or 736 but against the guarantor as well, particularly if the borrower is a single purpose entity whose only asset is the contaminated property that secures the loan. Also, where the guarantor is a third party (not the borrower or an alter ego of the borrower), the guaranty may be fully enforceable without regard to the debtor protection laws.

No "Standard" Documentation. There is significant variation in how lenders have chosen to document environmental provisions. Some lenders make no reference to Sections 726.5 and 736, apparently taking the position that their separate unsecured environmental indemnity and guaranty agreements work just fine. Others acknowledge the existence of Sections 726.5 and 736 but say that they do not apply to limit the unsecured indemnity (raising the issue whether those sections may be waived by the borrower). At the other extreme are lenders that include Sections 726.5 and 736 in their indemnity agreements as providing the limit of the circumstances under which the indemnity applies – and even include the provisions in the deed of trust without utilizing a separate unsecured indemnity at all – effectively conceding that Sections 726.5 and 736 are controlling and preclude a more expansive unsecured environmental indemnity.

Whatever approach lenders take, they have generally standardized their loan documents pertaining to environmental remedies. The enforceability issue regarding separate, unsecured environmental indemnities may be hidden like a land mine awaiting a case where it makes a difference, where the stakes are high enough for a lender and borrower to fight over it to the point of an appellate court ruling.

Right of Inspection. California Civil Code Section 2929.5 provides a statutory right for secured lenders, under specified circumstances, to enter and inspect real property security to determine the existence, location, nature and magnitude of any past or present release or threatened release of any hazardous substance into, onto, beneath or from the real property security. That right is enforceable, if necessary, by court order without triggering the debtor protection laws.

Secured Party Exemption "Safe Harbor." In exercising any recourse provided for in loan and security documents, lenders should be mindful of the risk of incurring environmental liability as the owner or operator of contaminated real property. Lenders should be aware of the kinds of activities that they may undertake without incurring environmental liability pursuant to the secured party exemption under the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and the California analogue, the Carpenter Pressley Tanner Hazardous Substances Account Act. So-called "safe harbor" legislation has been enacted under those laws to provide a measure of protection for lenders dealing with real property security in a manner to protect their security interest (to and including foreclosure and resale) without exhibiting investment intent, as prescribed in the safe harbor legislation. Of course, the exemption may prove to be somewhat illusory if the lender must deal with the environmental problem in order to make the property marketable and resell it on peril of losing the safe harbor exemption if the property is not timely resold.

Conclusion. There is a complex interplay of laws and practical considerations that lenders and borrowers need to take into account as decisions are made regarding loan documentation in the first instance and subsequent enforcement in the context of potential environmental liability. Lenders and borrowers should obtain legal advice from attorneys familiar with the legal principles and risks involved.

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