

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

By Paul S. Rutter, Esq. (*original author*)
and Donald C. Nanney, Esq. (*update author*)

Part 1 of 2

Executive Summary

California law generally requires 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 has posed a substantial risk for lenders with environmentally impaired real property collateral because under certain federal and state laws, a lender who forecloses on such property may be held liable for the environmental remediation of the property. However, a 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 the environmental contamination of the property. This little utilized option may be more relevant than ever for consideration by lenders during this time of recession and real estate loan defaults.

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, as the lender may be exposed to liability under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA") by becoming

the record 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 real 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, 1992.² 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 cleanup 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 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

Continued.



Paul S. Rutter is a Co-Chief Operating Officer & General Counsel of Thomas Properties Group in Los Angeles, Calif. Contact him at prutter@tpgre.com.



Donald C. Nanney is a partner at Gilchrist & Rutter in Santa Monica, Calif. His practice focuses on Environmental law, including environmental aspects of business and real estate transactions. Contact him at dnanney@gilchristutter.com.

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).

Legislative Compromise and Usefulness

The right to waive the security interest in environmentally impaired real property was sought by the banking industry and other financial companies in the lending business and was opposed by environmental organizations (which did not want lenders to have a way out from environmental liability) as well as by building owner and developer interests (which were major borrowers and wished to retain full benefit of the debtor protection laws). As one might expect where lobbying is intense on both sides of the issue, the result was complex lender relief legislation that contained numerous limitations and hurdles as summarized above. Perhaps for that reason it appears that Section 726.5 has not been utilized frequently by lenders, as there is no history of disputes arising during the last 20 years under Section 726.5, at least not to the point of reported appellate court decisions. Thus, the interpretation and application of the various provisions in Section 726.5 remain unaided by past court decisions.

In addition, several years after Section 726.5 was enacted, "safe harbor" rules were adopted under both federal and California law allowing lenders to foreclose and take ownership of real property collateral and still retain the benefit of a "secured party exemption" under environmental laws, provided that certain limitations and requirements of the "safe harbor" are satisfied (a subject beyond this commentary). The "safe harbor" rules may reduce the need for lien waiver under Section 726.5.

However, even if the "safe harbor" would apply, a lender may still have to deal with the environmental problem and may face economic loss in connection with an environmentally impaired property, so that the liability exemption may be somewhat illusory in order to make the property marketable

after foreclosure. Accordingly, it may be helpful for lenders to know of the option to waive the security interest and pursue the borrower directly on the debt as a possible avenue when faced with the conundrum of environmentally impaired real property security, a scenario that may be more relevant than ever during the current deep recession in the general economy with significant downturn in real estate values and increased rate of real estate loan defaults.

Endnotes

- (1) 42 USC § 9601 (20)(A).
- (2) CCP §§ 726.5 (a) and (g).
- (3) CCP § 726.5 (e)(5).
- (4) CCP § 726.5 (e)(1).
- (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).

Paul S. Rutter, Esq.: Co-Chief Operating Officer & General Counsel of Thomas Properties Group in Los Angeles, CA, (213) 233-9753.

Donald C. Nanney, Esq.: Partner, Gilchrist & Rutter, 1299 Ocean Ave., Ste. 900, Santa Monica, CA 90401, (310) 393-4000.

Published in Commentaries & Bulletins of Korek Land Company, Inc.
<http://www.korekland.com/commentaries.htm>