DCU BULLETIN

Division of Credit Unions

Washington State Department of Financial Institutions

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Environmental Risk on OREO Property

The Division of Credit Unions has been asked if a credit union may form a Credit Union Service Organization (CUSO) to hold and dispose of other real estate owned. This Bulletin provides guidance on what might a Division of Credit Unions Examiner ("Examiner") consider when reviewing:

(1) A Credit Union's decision whether to hold and dispose of other real estate owned ("OREO") through a subsidiary Credit Union Service Organization ("CUSO"); and

(2) A Credit Union's formation and operation of a CUSO to hold and operate OREO, particularly when the OREO poses a significant risk of environmental harm?

Environmental Risk Program

⇨ The Examiner will request a Credit Union's environmental risk policy, if one exists.

If a Credit Union has a reasonably foreseeable prospect of being involved with mortgage collateral that poses a measurable risk of environmental harm, then a Credit Union should adopt and maintain an environmental risk program. A Credit Union's first encounter with the real potential of toxic waste or other environmental harm on specific mortgage collateral should prompt a Credit Union to adopt a written environmental risk policy and implement it.

As an integral part of this guidance, the Examiner will look to see whether a Credit Union's environmental risk program is in conformity with The National Credit Union Administration's *Environmental Liability: Risk Management Guidance*, NCUA Letter No.: 08-CU-13, dated May 2008, which is attached and made a part of these guidelines as *Appendix A*.

Environmental Risk Assessment

⇨ The Examiner will request and then review a Credit Union's environmental risk assessment (if any).

Prior to starting the foreclosure process on a mortgage loan, a Credit Union should always make a reasonable determination whether the property subject to foreclosure poses any environmental risk and be prepared to discuss how it made its determination with the examiner.

In most cases, such a *reasonable determination* will not require a formal analysis or inspection of the property. Different kinds of property tend to pose varying levels of potential environmental risk.

For example, a ten year-old owner-occupied house built in compliance with strong building codes in a subdivision that was approved by a diligent planning department is likely not to pose any environmental risk. In that case, unless a Credit Union knows of any existing environmental hazard involving the house or any neighboring property, a Credit Union has no reasonable expectation of an environmental risk to its mortgage collateral.

On the other hand, there are two general categories of mortgage collateral that will require some level of environmental risk assessment prior to starting the foreclosure process. The first of these categories involves a known environmental hazard either (1) existing on the property itself or (2) proximate to it and posing a threat to the environmental stability of a Credit Union's collateral. In such a case, a Credit Union should strongly consider a formal environmental risk assessment prior to making a decision whether or how to foreclose. The second category is somewhat more discretionary on the part of a Credit Union but will require at least an informal assessment. This category involves a situation in which there is no known environmental hazard on or proximate to the mortgage collateral but the type of property is one in which there is a greater likelihood of actual environmental risk. Typical examples of this involve retail outlets selling gasoline and industrial sites. In addition, unimproved land may pose environmental risks that are not readily perceived without first making an inspection. Indeed, such an inspection could reveal that the unimproved land has been used as an illegal dumping ground for waste. The waste does not have to include hazardous chemicals to pose a threat. For example, a dump filled with used tires may produce toxic residue that can pollute nearby streams or ground water, causing harm to neighboring properties.

Cost-Benefit Assessment

⇨ The Examiner will ask for and then review the cost-benefit assessment on how a Credit Union determined the appropriate action to take on the delinquent loan.

If, after making either an informal *or* formal assessment (as necessary), the Credit Union determines that specific mortgage collateral poses actual environmental risk or the reasonable likelihood thereof, then another threshold decision needs to be made. In some rare instances, the cost of "cleaning up" a foreclosed property or the discounted value of the mortgage collateral when factoring the cost of remediation is such that it may not be worth foreclosing. In other words, the anticipated net recovery may be so little that it would not be worth the off-setting remediation costs plus increased exposure, as a subsequent owner, to environmental lawsuits. This is a decision that ought to be made in partial consultation with independent, knowledgeable legal counsel.

Additionally, e*nvironmental* liens may have priority over a prior-recorded mortgage or the latter, otherwise having priority, may be subordinated to the environmental lien because of conduct by a mortgage lender. This may involve violating the conditions of priority contained in federal or state hazardous waste laws or accepting a deed in lieu of foreclosure and thereby taking subject to existing liens. The presence of environmental liens should always be a consideration whether to foreclose on mortgage collateral.

In addition to providing a copy of its written cost-benefit analysis to the examiner, the Credit Union should be prepared to discuss its risk assessment with the examiner.

Legal Liability Risk Opinion

⇨ The Examiner will ask for and review any legal liability risk opinions obtained in connection with OREO.

A Credit Union should always obtain the advice of knowledgeable legal counsel when evaluating the Credit Union's and/or CUSO's exposure to legal liability for toxic waste and other environmental harm. The DCU Interpretive Letter I-10-04, dated August 9, 2010, discusses the importance of obtaining the advice of knowledgeable legal counsel when making decisions related to potential liability for toxic waste and other environmental harm. When a Credit Union has made pre-OREO decisions in the presence of measurable risk of environmental harm, the Examiner will look to whether a Credit Union and/or its CUSO have obtained an opinion from knowledgeable legal counsel in making an OREO decision.

So that a Credit Union may appreciate the importance of such a legal liability risk opinion, see *A Brief Summary of Environmental Liability and Exceptions*, attached and made a part of this guidance as *Appendix B*.

Formation and Capitalization of the Foreclosing Entity

⇨ The Examiner will review the following safety and soundness practices of foreclosing and disposing of property through a CUSO. As part of this review, the Examiner will consider, among other relevant issues:
   (1) The existence of a legal opinion from concerning all issues of capitalization, formation and operation of the CUSO, including:
      a) Maintenance of separate identity and limiting the risk of personal liability to the Credit Union;
      b) Operational best practices; and
      c) Limiting liability to the Credit Union for toxic waste or other environmental harm;
   (2) The type of CUSO formation (corporation or LLC);
   (3) The means by which the OREO was acquired (foreclosure, deed in lieu of foreclosure, or other method);

(4) The accounting practices employed (including whether the CUSO financials have been consolidated with a Credit Union's financial statements).

Examiners will look for best practices (in the following order):

(1) Form a CUSO;
(2) Transfer the mortgage loan to the CUSO;
(3) Proceed to have the CUSO foreclose on the property;
(4) Have the CUSO take title to the property as OREO; and
(5) Hold and dispose of the OREO in the name of the CUSO.

Since the CUSO is an investment under RCW 31.12.436(8), a Credit Union should notify the Division and obtain a non-objection if the investment in the CUSO will exceed 1% of assets and that it meets the criteria of safe and sound practices on disposing of OREO. See DCU Interpretive Letter I-10-04.

The Credit Union should consult with knowledgeable legal counsel as for what form of entity the CUSO should take, such as a Subchapter S corporation or a limited liability company ("LLC") as a subsidiary of a Credit Union.

The Division of Credit Unions considers it a *best practice* for a Credit Union to capitalize the CUSO in a manner similar to best practices we found with banks that use a subsidiary to dispose of OREO. In general, a standard best practice of banks is to transfer to the books of a subsidiary corporation or LLC initial paid-in capital of at least 10% of the value of the loan asset being foreclosed and thereafter maintain a liquidity ratio relative to the value of the loan asset or OREO of at least 10%. Any draw down of the subsidiary's liquidity due to operating expenses is typically replenished by the bank quarterly.

<u>Transfer of Loan Asset to CUSO</u>

⇨ The Examiner may review the accounting to determine if it complies with generally accepted accounting principles.

The examiner will review how the Credit Union transferred the mortgage loan asset to the CUSO. Typically, the examiner will find a Credit Union has transferred the mortgage loan asset to the CUSO by Assignment of Promissory Note and recorded Assignment of Beneficiary's Interest in Deed of Trust.

The CUSO should follow generally accepted accounting principles (GAAP). For accounting purposes, a Credit Union should make a credit to the mortgage loan on a Credit Union's books and then immediately write it down.

On the CUSO's books, record a *debit* in the "due from" and make an off-setting credit as a "due to" to complete the financial recording of the transfer of the mortgage loan asset to the CUSO.

If a Credit Union were to foreclose the mortgage loan and then transfer the collateral when it is already OREO it would defeat the entire purpose of limiting the exposure of a

Credit Union to environmental risk, since a Credit Union would have potential liability as an intermediate holder.

The Foreclosure or Deed in Lieu of Foreclosure Process

⇨ The Examiner will review the OREO file with regard to the process of foreclosure or deed in lieu of foreclosure.

The CUSO should be prepared to discuss with the examiner the process of foreclosure.

The CUSO has the choice of judicial or non-judicial deed of trust sale. The procedures regarding both options are entirely governed by the laws of the state where the collateral resides.

If the property was not acquired through foreclosure, the Examiner will review the legal opinion/analysis for the action taken. In the normal course, a deed in lieu of foreclosure subordinates the grantee (CUSO) to all liens that attach to the property that would be otherwise junior to a Credit Union's mortgage lien. A deed in lieu of foreclosure is a much simpler process, although it should not to be used as an alternate without the advice of independent, knowledgeable legal counsel.

Disposition of the OREO

⇨ The Examiner will review the disposition records for OREO.

Once in possession of the mortgage by foreclosure or deed in lieu of foreclosure, the CUSO will then proceed to dispose of the property as OREO according to the DCU Bulletin B-09-10 (Final Rule on Other Real Estate Owned (OREO), including addressing all environmental risk issues.

Upon the CUSO's sale of the OREO to a third party, CUSO's books will reflect a "debit" in cash and an off-setting "credit" to OREO. The CUSO will take the loss or gain on its books, which will in turn be reflected on the consolidated books and records of a Credit Union.

Closing

This Bulletin is intended for general guidance and is not a substitute for legal advice to Credit Unions.

Appendix A of Bulletin B-10-04

This is a reprint of the Federal Deposit Insurance Corporation's *Environmental Liability Updated Guidelines for an Environmental Risk Program,* FIL-98-2006 (dated November 13, 2006). This reprint is for regulatory purposes and not for commercial use.

GUIDELINES FOR AN ENVIRONMENTAL RISK PROGRAM

The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws are important factors in evaluating real estate transactions and making loans secured by real estate. Thus, institutions should maintain an environmental risk program in order to evaluate the potential adverse effect of environmental contamination on the value of real property and the potential environmental liability associated with the real property. As part of the institution's overall decision-making process, the environmental risk program should establish procedures for identifying and evaluating potential environmental concerns associated with lending practices and other actions relating to real property.

The board of directors should review and approve the program and designate a senior officer knowledgeable in environmental matters responsible for program implementation. The environmental risk program should be commensurate with the institution's operations. That is, institutions that have a heavier concentration of loans to higher risk industries or localities of known contamination may require a more elaborate and sophisticated environmental risk program than institutions that lend more to lower-risk industries or localities. For example, loans collateralized by 1- to 4-family residences normally have less exposure to environmental liability than loans to finance industrial properties.

ELEMENTS OF AN ENVIRONMENTAL RISK PROGRAM

The environmental risk program should provide for staff training, set environmental policy guidelines and procedures, require an environmental review or analysis during the application process, include loan documentation standards, and establish appropriate environmental risk assessment safeguards in loan workout situations and foreclosures.

Training

The environmental risk program should incorporate training sufficient to ensure that the environmental risk program is implemented and followed within the institution, and the appropriate personnel have the knowledge and experience to determine and evaluate potential environmental concerns that might affect the institution. Whenever the complexity of the environmental issue is beyond the expertise of the institution's staff, the institution should consult legal counsel, environmental consultants, or other qualified experts.

Policies

When appropriate, loan policies, manuals and written procedures should address environmental issues pertinent to the institution's specific lending activities. For example, the lending manual may identify the types of environmental risks associated with industries and real estate in the institution's trade area, provide guidelines for conducting an analysis of potential environmental liability, and describe procedures for the resolution of potential environmental concerns. Procedures for the resolution of environmental concerns might also be developed for credit monitoring, loan workout situations, and foreclosures.

Environmental Risk Analysis

Prior to making a loan, an initial environmental risk analysis needs to be conducted during the application process. An appropriate analysis may allow the institution to avoid loans that result in substantial losses or liability and provide the institution with information to minimize potential environmental liability on loans that are made. Much of the needed information may be gathered by the account officer when interviewing the loan applicant concerning his or her business activities. In addition, the loan application might be designed to request relevant environmental information, such as the present and past uses of the property and the occurrence of any contacts by Federal, state or local governmental agencies about environmental matters. It may be necessary for the loan officer or other representative of an institution to visit the site to evaluate whether there is obvious visual evidence of environmental concerns.

Structured Environmental Risk Assessment

Whenever the application, interview, or visitation indicates a possible environmental concern, a more detailed structured investigation by a qualified individual may be necessary. This assessment may include surveying prior owners of the property, researching past uses of the property, inspecting the site and contiguous parcels, and reviewing company records for past use or disposal of hazardous materials. A review of public records and contact with Federal and state environmental protection agencies may help determine whether the borrower has been cited for violations concerning environmental laws or if the property has been identified on Federal and state lists of real property with significant environmental contamination. The institution’s policies and procedures should reflect adequate consideration of the Environmental Protection Agency’s (EPA) “All Appropriate Inquiry Rule.”

EPA All Appropriate Inquiry Rule – In January 2002, the Congress amended the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) to establish, among other things, additional protections from cleanup liability for a new owner of a property. The bona fide prospective purchaser provision establishes that a person may purchase property with the knowledge that the property is contaminated without being held potentially liable for the cleanup of contamination at the property. The new owner must meet certain statutory requirements to qualify as a bona fide prospective purchaser and, prior to the date of acquiring the property, undertake “all appropriate inquiries” into the prior ownership and uses of the property.

In November 2005, the EPA promulgated its "Standards and Practices for All Appropriate Inquiries" final rule (EPA All Appropriate Inquiry Rule) which establishes the standards and practices that are necessary to meet the requirements for an "all appropriate inquiry" into the prior ownership and uses of a property. The All Appropriate Inquiry Rule will become effective on November 1, 2006.

An environmental evaluation of the property that meets the standards and practices of the EPA All Appropriate Inquiry Rule will provide the borrower with added protection from CERCLA cleanup liability, provided the borrower meets the requirements to be a bona fide purchaser and other statutory requirements. This protection, however, is limited to CERCLA and does not apply to the Resource Compensation and Recovery Act (RCRA), including liability associated with underground storage tanks, and other Federal environmental statutes, and, depending on state law, state environmental statutes. In addition, such an environmental evaluation may provide a more detailed assessment of the property than an evaluation that does not conform to the EPA All Appropriate Inquiry Rule.

As part of its environmental risk analysis of any particular extension of credit, a lender should evaluate whether it is appropriate or necessary to require the borrower to perform an environmental evaluation that meets the standards and practices of the EPA All Appropriate Inquiry Rule. This decision involves judgment and may be made on a case-by-case basis considering the risk characteristics of the transaction, the type of property, and the environmental information gained during an initial environmental risk analysis. If indications of environmental concern are known or discovered during the loan application process, an institution may decide to require the borrower to perform an environmental evaluation that meets the requirements of the EPA All Appropriate Inquiry Rule.

The decision to require the borrower to perform a property assessment that meets the requirements of the EPA All Appropriate Inquiry Rule should be made in the context of the institution's overall environmental risk program. An environmental risk program should be designed to ensure that the institution makes an informed judgment about potential environmental risk and considers such risks in its overall consideration of risks associated with the extension of credit. In addition, an institution's environmental risk program may be tailored to the lending practices of the institution. Thus, an institution should make its decision concerning when and under what circumstances to require a borrower to perform an environmental property assessment based on its own environmental risk program as tailored to the needs of the lending practices of the institution. Individuals involved in administering an institution's environmental risk program should become familiar with these statutory elements. One source for information concerning the EPA All Appropriate Rule is the EPA website at http://www.epa.gov/brownfields/regneg.htm.

Monitoring

The environmental risk assessment should continue during the life of the loan by monitoring the borrower and the real property collateral for potential environmental concerns. The institution should be aware of changes in the business activities of the borrower that result in a significant increased risk of environmental liability associated with the real property collateral. If there is a potential for environmental contamination to adversely affect the value of the collateral, the institution might exercise its rights under the loan to require the borrower to resolve the environmental condition and take those actions that are reasonably necessary to protect the value of the real property.

Loan Documentation

Loan documents should include language to safeguard the institution against potential environmental losses and liabilities. Such language might require that the borrower comply with environmental laws, disclose information about the environmental status of the real property collateral and grant the institution the right to acquire additional information about potential hazardous contamination by inspecting the collateral for environmental concerns. The loan documents might also provide that the institution has the right to call the loan, refuse to extend funds under a line of credit, or foreclose if the hazardous contamination is discovered in the real property collateral. The loan documents might also call for an indemnity of the institution by the borrower and guarantors for environmental liability associated with the real property collateral.

Involvement in the Borrower's Operations

Under CERCLA and many state environmental cleanup statutes, an institution may have an exemption from environmental liability as the holder of a security interest in real property collateral. In monitoring a loan for potential environmental concerns, and resolving those environmental situations as necessary, an institution should evaluate whether its actions may constitute "participating in the management" of the business located on the real property collateral within the meaning of CERCLA. If its actions are considered to be participation in the management, the institution may lose its exemption from liability under CERCLA or similar state statutes.

Foreclosure

A lender's exposure to environmental liability may increase significantly if it takes title to real property held as collateral. An institution should evaluate the potential costs and liability for environmental contamination in conjunction with an assessment of the value of the collateral in reaching a decision to take title to the property by foreclosure or other means. Based on the type of property involved, a lender should consider including as part of this evaluation of potential environmental costs and liability an assessment of the property that meets the requirements of the EPA All Appropriate Inquiry Rule.

SUPERVISORY POLICY

Examiners will review an institution's environmental risk program as part of the examination of its lending and investment activities. When analyzing individual credits, examiners will review the institution's compliance with its own environmental risk program. Failure to establish or comply with an appropriate environmental program will be criticized and corrective action required.

Appendix B to Bulletin B-10-04

A BRIEF SUMMARY OF ENVIRONMENTAL LIABILITY AND EXCEPTIONS

In order for Credit Unions to fully appreciate the requirements the guidance in Bulletin B-10-04, it is useful to briefly summarize environmental law from the perspective of liability and its exceptions. In this regard, we note preliminarily the recent guidelines from the Federal Deposit Insurance Corporation ("FDIC"), which have been incorporated as part of the Division of Credit Unions' own guidelines contained in Bulletin B-10-04.[1]

Federal Law. For our purposes, the most important federal environmental laws are the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA"),[2] and the Resource Conservation and Recovery Act of 1976 ("RCRA").[3] After the initial enactment of CERCLA and RCRA, there was much litigation over the notion of "lender liability" for the cleanup of environmental hazards on OREO.[4]

The secured creditor case that galvanized the lending community to demand clarification and limitation of liability was *United States v. Fleet Factors Corp.,* 901 F.2d 1550 (11th Cir. 1990)(*Fleet II*), in which the Eleventh Circuit Court of Appeals ruled that the lender in that case was not entitled to the secured creditor exemption contained in original language of CERCLA because its involvement in the management of its borrower "indicat[ed] a *capacity to influence* the corporation's treatment of hazardous wastes." Because almost all lenders maintain the capacity to influence a borrower's financial affairs and operating decisions, *Fleet Factors* led to a full-scale effort by the lending and business community to reverse the impact of the court's decision and provide clearer liability rules for lenders.[5]

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[1] See FDIC, *Environmental Liability Updated Guidelines for an Environmental Risk Program,* FIL-98-2006 (dated November 13, 2006), available at *Appendix A* of Bulletin B-10-04.

[2] 42 U.S.C. §9601, *et seq.*

[3] Pub.L. No. 94-580, 90 Stat. 2795 (varied codification).

[4] As initially adopted in 1980, and continuing today, CERCLA establishes that "any person" is responsible for the costs of addressing "hazardous substances" if that person is either a current or former "owner or operator" of a "facility" from which a "release" of such substances has occurred. 42 U.S.C. §9607(a). These categories of liability were modified by CERCLA's further definition of "owner or operator." Specifically, Congress provided that a "person" would not be considered an "owner or operator" if, "without *participating in the management* of a vessel or facility, [a person] holds indicia of ownership primarily to protect his security interest in the vessel or facility." [Emphasis added.] 42 U.S.C. §9601(20)(A). In contrast to liable parties who have a defense to CERCLA liability (42 U.S.C. §9607(b)), those with a security interest were defined out of CERCLA's broad owner/operator liability scheme. As initially interpreted by the courts, however, the secured creditor exemption did not provide the assurance that most lenders needed in order to understand and limit the risks of investment in real estate or other transactions that could be affected by environmental liabilities. From 1985 to the mid-1990s, courts issued conflicting opinions about the protection afforded lenders under CERCLA exemption.

[5] Right after *Fleet Factors*, the Environmental Protection Agency ("EPA") attempted to define and limit the scope of CERCLA liability by rulemaking, including addressing what "participation in management" by a lender meant. See 57 Fed. Reg. 18,344 (April 29, 1992). This attempt to administratively provide some relief to the lending community was overturned, however, in *Kelley v. EPA,* 15 F.3d 1100 (D.C.Cir. 1994), which only made the controversy worse.

Congress finally responded in 1996 by enacting the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 ("Lender Liability Act"),[6] which explicitly voided the "capacity to influence" portion of the court's decision in *Fleet Factors* and, as part of its definition of "participate in management," adopted a more lender-friendly standard. The Lender Liability Act describes a lender's "actual participation" before, during, and after the financing transaction, including after default and during workout. Under the Lender Liability Act, lenders are not considered owners or operators, even if they foreclose and then sell, re-lease, liquidate the facilities, maintain business activities, wind up operations, undertake a response action, or take any other measure to preserve, protect, or prepare a site for sale or other disposition, if the lender seeks to do these things "at the earliest practicable, commercially reasonable time, on commercially reasonable terms."[7] The determination of what is "commercially reasonable" takes into account market conditions, as well as legal and regulatory requirements.[8] "Participate in management" is the most important term in the lender protection provisions. In general, the term "participate in management" now "means actually participating in the management or operational affairs" of the site,[9] and "does not include merely having the capacity to influence . . . facility operations."[10]

Although the Lender Liability Act provides significant clarification and protection to lenders, they must still exercise caution to avoid undertaking activity that *voids* the exemption. Even after passage of the Lender Liability Act, a court reviewed Fleet's actions again and found that the extensive involvement of the lenders' agents in the mismanagement of hazardous materials on-site resulted in the loss of the protection provided by the lenders' exemption under the new lender liability amendments.[11] Despite the additional protections for lenders afforded by the Lender Liability Act, lenders continue to be sued for response costs.[12]

The second significant source of federal environmental liability for lenders is the RCRA and related state enforcement. The RCRA provides comprehensive regulation of the handling, storage, treatment, transport, and disposal of hazardous and nonhazardous waste, including petroleum-related materials.[13] Most of these regulations are not likely to apply to lenders unless they operate the waste operations at a facility, an unlikely scenario, particularly given the intent of lenders to take advantage of CERCLA's lender

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[6] Pub.L. No. 104-208, 110 Stat. 3009-462.

[7] 42 U.S.C. §9601(20)(E)(ii).

[8] 42 U.S.C. §9601(20)(E)(ii).

[9] 42 U.S.C. §9601(20)(F)(i)(I).

[10] 42 U.S.C. §9601(20)(F)(i)(II).

[11] *United States v. Fleet Factors Corp.,* 821 F.Supp. 707, 720 (S.D.Ga. 1993) (*Fleet III*).

[12] *See, for example, ITT Commercial Finance Corp. v. Harsco Corp.,* No. 91-CV-0793 (FJS), 2000 U.S.Dist. LEXIS 13376 (N.D.N.Y. Jan. 3, 2000).

[13] 42 U.S.C. §§6901 – 6992k.

liability exemption. However, two sources of liability under RCRA impose particular concern for lenders: (1) liability for underground storage tanks ("USTs") that leak ("LUSTs"),[14] and (2) a citizen's suit for an "imminent and substantial endangerment" to public health or the environment.[15]

RCRA regulates USTs, including LUSTs.[16] As with CERCLA, the RCRA imposes broad liability on "owners" and "operators" of UST systems. Under the UST secured creditor rule, which applies solely to petroleum UST systems, a person holding a security interest is exempt from compliance with UST regulatory requirements from the time credit is extended through foreclosure, loan workout, and disposition of assets. However, for purposes of securing performance on an obligation, a holder may need to take possession of an UST system, an UST facility, or a piece of property on which an UST or UST system is located. The foreclosure process often involves the holder taking record title or deed to the UST, UST system, or the property to secure that obligation. The act of foreclosure displaces the borrower, and necessarily involves the holder taking "control of . . . and responsibility for" the tank, possibly subjecting the holder to liability as an "operator" under the RCRA.[17] EPA rules specify the parameters of a holder's ownership, operation, and other responsibilities following foreclosure on an UST site.[18] First, the holder may avoid liability as an operator if another person has control of or responsibility for the daily operation of the UST system and compliance with legal requirements.[19] The holder may arrange for a different person to operate the UST or UST system while the holder has possession of the UST, UST system, facility, or property on which the UST is located.[20] If an operator does not exist to bear responsibility for the UST or UST system, a holder still may avoid liability as an "operator" if the holder –

(1) Empties the USTs within 60 calendar days after foreclosure or discovery or within another reasonable time period specified by the implementing agency so that no more than 1 inch of residue (2.5 centimeters), or 0.3 percent by weight of the total capacity of the UST system, remains in the system;
(2) Leaves vent lines open and functioning; and
(3) Caps and secures all lines, pumps, manways, and ancillary equipment.[21]

[14] 42 U.S.C. §§6991a – 6991m.

[15] 42 U.S.C. §6972.

[16] 42 U.S.C. §§6991a – 6991m.

[17] 60 Fed.Reg. at 46,695.

[18] 40 C.F.R. §280.230(a).

[19] 40 C.F.R. §280.230(b)(1).

[20] 60 Fed.Reg. at 46,703.

[21] 40 C.F.R. §280.230(b)(i).

After foreclosure, in addition to emptying and securing the UST or UST system, holders must also comply with the requirements for temporary or permanent closure to avoid being deemed an "operator" of the UST.[22] A holder who permanently or even temporarily closes a UST or UST system must comply with a range of EPA rules, except for the requirement to perform corrective actions if contamination is discovered.[23] Failing to satisfy these post-foreclosure conditions or otherwise being held by a court to have performed one's responsibility negligently or recklessly could lead to status as an "operator," which subjects the holder to all of the obligations of tank operators, including corrective action regulations.[24] In addition, if lenders' activities, particularly during foreclosure, violate other RCRA provisions, such as those pertaining to hazardous waste management and state or regional solid waste plans, RCRA's liability may be imposed. Because lenders are still at risk for RCRA liability, lenders are well-advised to implement environmental risk programs, such as those required by FDIC guidelines.[25]

Another source of RCRA liability is the language authorizing "citizen suits."[26] Any "person" is authorized to bring a lawsuit to obtain a court order to address contamination that "may present an imminent and substantial endangerment to health or the environment."[27] Such a lawsuit may be brought "against any person . . . who *has contributed or who is contributing to* the past or present handling, storage, treatment, transportation, or disposal" of waste. [Emphasis added.][28] ***The RCRA citizen suit provisions do not contain any exemption from liability for secured creditors.*** Instead, lenders' principal defense to liability is likely to be the "contributing to" language of the statute. Although courts have broadly interpreted the phrase "contributing to," there must be some "causal relationship" or "causal connection" between the contamination and the liable party.[29] There appear to be no reported court decisions which discuss what activities performed by lenders constitute "contributing to" waste activities. However, a lender's activities *following foreclosure* are more likely to result in a finding that the lender has "contributed to" the activities causing the contamination.

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[22] 60 Fed.Reg. at 46,703.

[23] 40 C.F.R. §§280.71 through 280.74; 40 C.F.R. §280.230(b).

[24] 60 Fed.Reg. at 46,703.

[25] See *Footnote 14*.

[26] 42 U.S.C. §6972.

[27] 42 U.S.C. §6972(a)(1)(B).

[28] 42 U.S.C. §6972(a)(1)(B).

[29] *See, e.g.*, *Aurora National Bank*, 990 F.Supp.1020 (N.D.Ill. 1998) (following *Zands v. Nelson*, 797 F.Supp. 805 (S.D.Ca. 1992), which state there must be "causal relationship between a defendant and an imminent and substantial endangerment" to find that party "contributed to" contamination); *Triffler v. Hopf*, No. 92 C 7193, 1994 U.S.Dist. LEXIS 16158 at *11 (N.D.Ill. Oct. 31, 1994) (requiring "some sort of causal connection" between disposal and PRP to find that party "contributed to" contamination).

Washington State Law. Washington State has its own statute for hazardous waste cleanup, the Model Toxic Controls Act ("MTCA"),[30] which was originally enacted by an initiative of the people[31] and which may be enforced by the Department of Ecology and private citizens. The provisions of the MTCA contain many, though not all, of the same definitions that exist in CERCLA and the RCRA.

Under the MTCA, an "owner or operator" is any person with an ownership interest in property or who exercises control over that property, or where there has been abandonment, any person who owned or exercised control prior to abandonment.[32] A "holder" includes a mortgage lender that has a deed of trust or mortgage on property as security for a debt owed by an owner/borrower.[33] "Operating a facility primarily to protect a security interest" occurs when all of the following are met: (a) Operating the facility where the borrower has defaulted on the loan or otherwise breached the security agreement; (b) operating the facility to preserve the value of the facility as an ongoing business; (c) the operation is being done in anticipation of a sale, transfer, or assignment of the facility;* and *(d) the operation is being done primarily to protect a security interest. Operating a facility for longer than one year prior to foreclosure or its equivalents shall be presumed to be operating the facility for other than to protect a security interest.[34]

The status of "owner or operator" is a critical threshold to liability under the MTCA. A mortgage lender is not an "owner or operator" if the lender does not participate in the management of the property. Mortgage lenders ("holders") who foreclose on property, engage in "workouts" without managing the property,* or *prepare a property for sale or assignment, are* exempt *from the status of "owner or operator" if:

1. ***They maintain environmental compliance measures already in place on subject property;***
2. ***They comply with reporting requirements under the Department of Ecology's MTCA Rules;***
3. ***They comply with any order issued to them by the Department of Ecology to abate an imminent or substantial endangerment;***
4. ***They allow the Department of Ecology or potentially liable persons under an order, agreed order, or settlement agreement access to the subject property to***

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[30] Chapter 70.105D RCW.

[31] Initiative Measure No. 97, approved November 8, 1988.

[32] RCW 70.105D.020(17).

[33] RCW 70.105D.020(11) and (13).

[34] RCW 70.105D.020(16).

conduct remedial actions and do not impede the conduct of such remedial actions;

5. ***Their remedial actions are in compliance with Department of Ecology specified requirements or rules; and***
6. ***They do not exacerbate an existing release of toxic substances.***

***In addition, one can still be exempt from the status of "owner or operator" if a hazardous substance has come to be located on the subject property as a result of migration through groundwater provided that certain strict conditions are met.*[35] *A lender ("holder") who forecloses and then holds OREO for longer than five (5) years may, under the MTCA's intricate definitions, lose its exemption from the status of "owner or operator."*[36]**

***If a person is not exempt or loses exemption from the status of "owner or operator," that person is* strictly liable *for all remedial costs and for all consequential damages and costs,* unless*: (1) the environmental harm in question was caused by an act of God, act of war, or act or omission of an unrelated third party; (2) the person can establish no reason to have known that such harm existed on the property; (3) a hazardous substance was used legally; or (3) a crop farmer uses pesticides or fertilizers without committing negligence and in compliance with all laws and regulations.*[37]**

***However, nothing in the MTCA prevents any person from suing under other statutes (e.g., CERCLA or RCRA) or the common law, including but not limited to damages for injury or loss resulting from a release or threatened release of a hazardous substance. No settlement by the Department of Ecology or remedial action ordered by a court or the Department of Ecology affects any person's right to obtain a remedy under common law or other statutes.*[38]**

***If the State of Washington incurs remedial action costs and they are not recovered from the responsible parties, the Department of Ecology may file a lien against the property that has priority over all other security interests and liens (regardless of when incurred or filed),* except *for local and special district property taxes (LIDs) and mortgage liens recorded before liens or notices of intent to conduct remedial actions are recorded.*[39]**

With some exceptions, a person may bring a private right of action, including a claim for recovery of all remedial costs, contribution or for declaratory relief, against any "owner or operator," including a holder of OREO that is not exempt or has lost its exemption.[40]

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[35] RCW 70.105D.020(17) and (18)(e) through (g).

[36] RCW 70.105D.020(23).

[37] RCW 70.105D.040.

[38] RCW 70.105D.040(6).

[39] RCW 70.105D.055.

[40] RCW 70.105D.080.

Conclusion. Although lenders have greater protections than many other members of the business community, no investment is environmentally risk free. A lender's best practice is to have in place a process for ascertaining, evaluating, and managing environmental risks, as contemplated by the FDIC guidelines[41] and the Division of Credit Unions' Bulletin B-10-04. Moreover, in light of the afore-mentioned discussion of environmental liability under CERCLA, RCRA, the Lender Liability Act, MTCA, and common law equity and negligence, a CUSO should usually always be formed to hold and dispose of OREO that evidences any measurable risk of environmental liability. All lenders, including a Credit Union and its subsidiary CUSO, should make a disciplined analysis of real environmental risks and consider how they will manage those risks before making lending and OREO decisions.

[41] See *Footnote 1*.