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Environmental Lending and Foreclosure Risks in 2020

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Mark McPherson has spent over three decades developing his skills in environmental law, groundwater and surface water rights, land use, and real estate transactions. Mr. McPherson's practice includes permitting and compliance, enforcement defense, and remediation. Clients of the MCPHERSON LAW FIRM come from the complete spectrum of regulated entities, and are located all around Texas. His passionate commitment to his field has led to an in-depth understanding of complex issues and the ability to effectively counsel regulated entities involved in maintaining and managing the natural resources of Texas, so they can *Mess With Texas Legally*.

Mr. McPherson began his practice of law with a Big Law-type of firm in Dallas. After five years he opened his solo practice. Over his career he has invested substantial time and effort in many professional activities to connect him to his colleagues, increase his quality of life, and benefit his clients. His professional distinctions include:

- Awarded the *2017 Environmental Justice Award* by the Lone Star Chapter of the Sierra Club for his work to bring a safe water supply and sanitary sewer treatment services to Sandbranch, the most impoverished community in Dallas County, Texas.
- Awarded the *2011 Standing Ovation Award* from TexasBarCLE. The awards are given each year by the State Bar of Texas' continuing legal education department staff in appreciation for extraordinary dedication and commitment, as well as for being gracious and easy to work with.
- Awarded the *2011 Weatherbie Workhorse Award* for being a stalwart of real estate continuing legal education courses, recognizing his contributions as a speaker and author on whom the profession has come to depend.
- Course Director for the 2013 Changing Face of Water Rights Advanced Course, the 2011 Advanced Real Estate Law Course, and 2008 Advanced Real Estate Drafting Course, all sponsored by TexasBarCLE.
- Council Member of the State Bar of Texas' Real Estate, Probate and Trust Law Section, 2007-2011.
- Administrator of the Dallas Area Real Estate Lawyers Breakfast Discussion Group.
- Administrator and host of the TEXAS REAL ESTATE E-MAIL DISCUSSION GROUP, an e-mail based discussion group for professionals in the Texas real estate industry. Participation is free for qualified individuals. To join the discussion group please send an Email to mark@texasenvironmentallaw.com.

Mr. McPherson earned his B.S., *cum laude*, in Political Science from Belmont University, Nashville, Tennessee (1987) and his J.D. from Washington & Lee University School of Law, Lexington, Virginia (1990).

Mr. McPherson believes in a holistic lifestyle, and to that end he maintains some semblance of sanity and manages the various health challenges generated by his chosen profession by getting outdoors to long-distance road cycle, hunt and fish. He has been known to stop by Graceland to pay his respects to the King every time he passes through Memphis.

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I. SCOPE OF THIS PAPER

This paper explains a lender's risks and opportunities when a borrower files bankruptcy (debtor), where the lender has a deed of trust lien on real property collateral that is contaminated. The real property collateral is already affected by environmental contamination such that it is either already the subject of a formal enforcement process of the United States through the Environmental Protection Agency (EPA) or Department of Justice (DOJ), or the State of Texas through the Texas Commission on Environmental Quality (TCEQ) or Texas Office of Attorney General (OAG), or both state and federal actions, or is at least at risk of a formal enforcement action. As explained in detail below, bankruptcy splits enforcement remedies into multiple claims, and allocates different components of enforcement into different claims. And the automatic stay and other features of the Bankruptcy Code (Bankruptcy Code) affect environmental enforcement actions in very sophisticated ways.

This paper was first published during the COVID-19 pandemic as it affects the United States. Due to the business shut-down orders issued by state and local governments, it is expected that a wave of bankruptcies will affect most small businesses, along with many medium and larger sized business. Some authorities have compounded the challenges for landlords by ordering a moratorium on evictions. Even with a "v" shaped recovery, it is generally expected that it may take five years, more or less, to work through all the coming defaults. So I decided to write this paper now to assist real estate and bankruptcy practitioners through the coming bankruptcy pandemic.

II. WAR STORIES

It is helpful at the outset to consider several fact scenarios within the scope of this paper. Some of these stories are actual, some are fictional, some are a blend of both. In all instances names have been deleted to protect the innocent, the allegedly innocent, and the responsible parties.

A. RELEASE THE LIEN

I could not have known it at the time, but my introduction to this topic, and an effective strategy by the lender, occurred in about 1993 when I was in just my third year of practice. I represented the lender, in this case a bank that had extended a loan secured by a deed of trust lien on real property. The lender was owned by a partner at my law firm, who was also my boss at the time. The lender knew the real property was contaminated at the time the borrower defaulted. After I posted the property for foreclosure¹, the lender and this borrower set up a meeting to try to negotiate a workout.

The grandiose borrower's office looked like something straight from the *Dallas* TV show set. The borrower entity's officers laid out their proposed workout, which included a deed in lieu of foreclosure and a small payment of cash in return for a full release. My boss shocked the room by countering with "*I don't want that piece of property, it's contaminated and would cost more to fix than it's worth. I'm going to release the lien and sue you on the note and personal guarantees.*" Right about then, I think I could have heard a pin drop on that high-pile carpet.

As I was writing this paper, I imagined the following soliloquy:

*To foreclose, or not to foreclose, that is the question.
Whether 'tis nobler in the mind
To suffer the slings and arrows of outrageous environmental liability,
Or to take up arms against the sea of default solely on a note,
And by releasing the lien end it.*

To my complete surprise, the entire tenor of the conversation changed immediately, and while the parties did not reach a deal at that meeting, a workout was negotiated in very short order. The threat to only sue on the note, without taking title to the

¹ At this point in my career my job included documenting and conducting almost all foreclosures for the entire firm. And to curry favor with a local bankruptcy judge, this law firm arranged for Bankruptcy Court Judge Harold Abramson to swear me into the bar. I then discovered that I had been designated to handle all agreed motions and orders in his court.

real property, had the desired effect.

B. HAIRCUT ON SALE

Lender foreclosed on a defaulted loan, taking title to a 4 acre commercial strip center. Potential buyer performed normal due diligence on the property, and found that the property was affected by methane in soil from a release that had never been properly remediated. The lender decided to sell the property. But to close the sale, the lender had to reduce the purchase price in order to account for the contaminated condition. As a result, the lender realized a 33% loss on the loan.

The buyers installed a monitoring system to collect methane samples annually. This remediation action is being overseen by the TCEQ. If the methane samples ever reach a certain threshold volume, the new owners will have to add a venting system to capture and safely vent the methane releases. Once the methane releases decrease to a certain amount, the new owner may file a request with the TCEQ to cease further monitoring. Monitoring is expected to last from 10-15 years in total. So far the new owner has spent around \$125,000 to remediate this property, which is a fraction of the loss of fair market value realized by the lender in its sale to the new owner. The methane contamination pre-dated the original loan.

C. THE ABANDONED FORMER GAS STATION

In the 1940s a gas station was installed on a corner of a lot. When it was removed, some thirty years later, only the surface improvements were removed. The underground tanks and pipes remained. When a third party contracted to buy a property across the street from the former gas station, his Phase I Environmental Site Assessment (Phase I ESA) identified the underground storage tanks, which led to a Phase II Environmental Site Assessment (Phase II ESA) with core samples that showed this property was likely affected by a leak of petroleum substances. Putting two and two together, the former gas station infrastructure was determined by regulators to be the culprit.

Even though the former gas station tract was encumbered by a deed of trust lien, the City decided that this gas station was abandoned, and so it designated that area a Brownfield Site, obtained Superfund funds, and used those funds to investigate the tanks. It then used Superfund funds to remove the tanks and excavate contaminated soils both on the former gas station tract, across the City's right of way for the street, and then some of the parcel across the street. It then filed a cost recovery lien on the former gas station tract.

The owner of the former gas station tract defaulted on his loan, and then filed bankruptcy the day before the lender had scheduled its foreclosure sale. The lender chased the property through bankruptcy, finally winning a bankruptcy court order lifting the automatic stay and foreclosing on the property. The City's lien was junior to the lender's deed of trust lien, and so the foreclosure sale proceeds paid the lender's deed of trust lien in full, with the surplus paid to the City in partial satisfaction of its debt.

D. THE NEW INDUSTRY

Historically, Superfund expenditures have been used to clean up sites that used chemicals we did not know were hazardous to human health and the environment, where the damage, once understood, bankrupted entire industries. Creosote treatments and asbestos are two examples. There will be others in the future. While I fully support the modern effort to develop a market for industrial hemp, consider the possible legalization of marijuana. At an increased volume, will the plants in the field require new pesticides? Will manufacturers develop new chemicals or unique types of wastes that take twenty years for their toxicity to be fully understood? It does not take expensive, large sized production facilities to cause environmental contamination that becomes more expensive than the owner/operator/borrower/debtor can pay to remediate, leading to the owner/operator abandoning the contaminated collateral to the EPA, TCEQ and/or lender.

III. FEDERAL ENVIRONMENTAL LIABILITIES

Generally, the major federal statutes regulating human health and the environment delegate permitting and enforcement authority to the states, once a state adopts a regulatory scheme that meets minimum requirements. As a result, the substantial majority of administrative penalties, civil penalties, and criminal penalties, are imposed by state regulators. In Texas, the TCEQ has authority to issue necessary environmental permits, monitor compliance with those permits, and seek penalties for non-compliance. Federal law serves a very limited niche role in assessing environmental fines and enforcing

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