



News & Types: Real Estate Update

Allocating Environmental Liability Between a Lender and Borrower

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Practices: Real Estate

A common sticking point for lenders and borrowers when negotiating loan documents is how to fairly and appropriately allocate risk relating to environmental matters.

A starting point should be that, as between a borrower and a lender, the borrower should be responsible for all environmental liability associated with the property (excluding matters caused by the lender). The borrower owns and directly or indirectly controls the property while the lender is involved in the property only by virtue of making a loan to the property owner. Accordingly, it is both fair and appropriate for a lender to require an environmental indemnity from a borrower covering all environmental matters not caused by its lender.

But if an environmental matter arises on a property, should the borrower be in default under the loan documents? It depends. If, for example, the borrower hauled radioactive material onto the property and dumped it there, clearly the borrower breached its agreement not to release hazardous materials on the property, the environmental indemnity should be triggered, and a default should be declared.

If, however, unbeknownst to the borrower, another party released hazardous materials on the property and the borrower used commercially reasonable efforts to prevent it, the borrower will not have breached any agreement with its lender (as long as the environmental contamination is remediated in accordance with the loan documents). In this situation, even though environmental contamination exists and the environmental indemnity has been triggered, the borrower should not be in default under the loan documents.

Using this approach, the lender is protected from liability by the environmental indemnity, and the borrower is not in default for something that was not within its control. Meanwhile, the party best situated to address the environmental contamination (i.e., the borrower, as owner of the property) will be required under the loan documents to remediate the contamination.

This is a fair and appropriate outcome for both the lender and the borrower.

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