



**Question of the Month: What are PFAS? Forthcoming regulation and risk management for lenders - by Keith Brown, Michael DiLeo and Brianna Tibett**

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In the course of evaluating a potential lending transaction, both institutional and private lenders review a variety of metrics relating to both the borrower and the underlying collateral. The strength of a potential transaction will largely depend on things such as a borrower's credit history, borrower's cash flow, the strength of any guarantors, and the loan to value ratio of the property. Yet even when all other aspects of a deal are in order, the environmental condition of a collateral property can derail an otherwise straight forward transaction.

The potential risks for lenders associated with the environmental health of a property are two-fold. On the one hand, failure to detect contamination before entering into a transaction could cause the borrower's cash flow to be severely diverted if remediation becomes necessary during the term of the loan. On the other hand, inadequately protected lenders could face liability under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA or as it's more commonly known "Superfund") and other state and federal environmental regulations both during the loan and once the property has been foreclosed upon.

Recent reports from both the Environmental Protection Agency (EPA) and New York State recognizing the dangers of Per- and Polyfluoroalkyl Substances (PFAS) have created new environmental concerns for lenders and borrower's alike. According to the New York State Department of Environmental Conservation, PFAS belong to a class of approximately 4,700 synthetic chemicals used since the 1940s in the production of countless consumer and commercial products such as water-repellant clothing, food packaging, lubricants, plastics, pesticides, wire insulation, non-stick cookwear and fire-fighting foam. While PFAS have not been produced in the U.S. since 2015, other countries, such as China, India and Russia have now become leading manufacturers. In addition, remaining stocks of PFAS-laden products purchased before the phase out will remain in circulation in the marketplace for quite some time.

PFAS are a cause for concern due to their persistence in the environment and within the human body as a result of their high solubility, low absorption coefficient and resistance to degradation over time. Indeed, it's no surprise that such chemicals have earned the nickname "forever chemicals." While average, low-level exposure in the environment is not currently considered a health risk for humans, concentrated exposure due to a contaminated water source or food has been shown to lead to low birth weights, hormone disruption and cancer. In early 2016, New York State, along with Vermont and New Hampshire, urged the EPA to acknowledge the dangers posed by PFAS. In May of 2019, the EPA issued a lifetime health advisory of 70 parts per trillion for long-term exposure

through drinking water. As of this writing the EPA is taking steps to, but has not yet designated PFAS as a “hazardous substance” within the purview of CERCLA.

According to a report prepared by the New York Public Interest Research Group and released in May of 2019, the Long Island and Hudson Valley regions contain, by far, the most detected PFAS in sources of drinking water. That said, there remain 6.4 million New York residents served by untested water sources. Moreover, the state of New York has commenced a \$38 million lawsuit against manufacturers who use PFAS to recoup clean-up costs associated with extensive contamination in areas, such as Newburgh, Plattsburgh, and Southampton.

Complicating matters further for potential lenders, PFAS are currently under-regulated and difficult to test for in the first instance. The EPA has not yet classified PFAS as “hazardous substances” under CERCLA and, as a result, testing for PFAS is not a required scope item for a standard Phase I or Phase 2 environmental review. Furthermore, testing in and of itself is costly and difficult because many of the testing instruments and equipment, even something as simple as a permanent marker, contain PFAS and can corrupt test samples.

Given the knowledge of these new sources of environmental contamination, lenders should take necessary precautions both prior to closing, during the term of the loan and post-foreclosure in order to safeguard their investment.

Under CERCLA, property owners can face liability for contamination regardless of the source or fault of the initial exposure. With regard to newly regulated contaminants it is important to keep in mind that liability under CERCLA can be applied retroactively for contamination that took place prior to regulation. As such, for both borrowers and lenders a determination must be made prior to closing whether to incur the additional cost of testing on the assumption that PFAS may in the future become regulated.

Lenders, are, however, provided with a specific exemption from liability under CERCLA as they typically do not exert control over the property. There are, however, very important exceptions to this rule that lenders must keep in mind. CERCLA will not provide safe harbor to creditors in those instances where it can be argued that a lender participates in the management of the property. “Management of the property” in this case refers to any acts that can be categorized as decision-making control over hazardous substances or managerial control over day-to-day functions with respect to environmental related aspects of the property.

With the foregoing in mind, the most prudent courses of action with regard to potential collateral contamination by PFAS are as follows:

#### Environmental Due Diligence:

A comprehensive review of the environmental health of the collateral property should be undertaken both prior to closing and prior to foreclosure. This review should highlight existing contaminants, as well as the risk and cost of remediation and effect on the value of the collateral. Such due diligence

can be undertaken directly by the lender or a lender can rely on a borrower's investigation and report. With regard to PFAS, a lender must determine first whether a particular investment warrants the cost of additional testing and second, if contamination is discovered, whether the property warrants remediation.

#### Secured Creditor Environmental Insurance:

In those instances where contamination has been detected or where a borrower's operation of the property raises the possibility of contamination, a lender can seek out Secured Creditor Environmental Insurance as a protective measure in the structure of the deal. Upon the occurrence of both an event of default and detection of contamination, Secured Creditor Environmental Insurance policies typically cover: (a) the lesser of the outstanding loan amount or the cost of remediation; or (b) protection against third-party claims for bodily injury or property damage. Lenders can also structure the transaction, such that the borrower is required to cover the cost of the insurance premium during the term of the loan.

#### Environmental Indemnification:

Lenders should insist on strong environmental indemnification agreements as part of their transaction. Particularly in those instances where a lender's due diligence has identified specific contamination or the risk thereof, explicit reference should be made in the indemnification agreement to ensure adequate coverage. Further, careful attention should be paid to the description of "losses" incurred by the lender, as well as any representation and warranties made by the borrower and guarantors.

#### Avoid Direct Management of the Collateral:

As previously discussed, secured creditor liability under CERCLA arises primarily from the creditor's direct management of the property either during the term of the loan or post-foreclosure. Lenders should prefer to impose contractual obligations on the borrower to demonstrate environmental compliance in their use of the collateral property, rather than set specific operational guidelines.

With the federal government's anticipated hazardous substance designation, PFAS should be implemented in environmental due diligence considerations, addressed in the representations and warranties, included in the definition of hazardous substances within environmental indemnification agreements and contractual obligations should be created to ensure borrowers' environmental compliance. Moreover, just as lenders would seek Secured Creditor Environmental Insurance for the detection of regulated hazardous substances the same should be done when PFAS are detected. By taking these smart and careful steps, lenders can proactively manage their risk and exposure to environmental liability linked to PFAS.

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