Equity Participations and Lender Liability Under CERCLA

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I. INTRODUCTION

In recent years lenders have become more active and diversified in their approaches to investment in real estate development. The desire for flexibility and improved risk management in dealing with investment portfolios of long term debt has given rise to a barrage of alternative mortgage instruments and financing techniques.[1] In addition, lenders have sought to go beyond their traditional role as mere passive intermediaries whose return is limited to the interest on borrowed funds. Through use of techniques collectively known as "equity participations," lenders have sought the potentially higher profits available from sharing in the success of the borrower's real estate project.[2]

While lenders have systematically explored creative methods for increasing their potential profits through equity participations, they have been less receptive to the notion that with added

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1. *See, e.g.*, G. Nelson & D. Whitman, REAL ESTATE FINANCE LAW 776-800 (2d ed. 1985) [hereinafter Nelson & Whitman, FINANCE] (basic introduction to a variety of alternative mortgage instruments); Browne, *The Development and Broad Application of the Adjustable Rate Mortgage Loan: The Federal Home Loan Mortgage Corporation's Adjustable Rate Mortgage Loan Purchase Program and Mortgage Loan Instruments*, 47 MO. L. REV. 179 (1982); Guttentag, *Recent Changes in the Primary Home Mortgage Market*, 3 HOUSING FIN. REV. 221, 232-42 (1984) (identifying the potential variety of adjustable rate mortgages); Freeman, *Alternative Mortgage Instruments and Potential Mortgage Enforcement Problems*, 14 URB. LAW. 760-64 (1982); Iezman, *Alternative Mortgage Instruments: Their Effect on Residential Financing*, 10 REAL EST. L.J. 3-28 (1981); Marcis, *The Shake Out in Alternative Mortgage Instruments*, 13 REAL EST. L.J. 29-33 (1983); Comment, *The New Mortgages: A Functional Legal Analysis*, 10 FLA. ST. L. REV. 95-102 (1982) (analyzing the history of problems leading to the development of modern mortgage instruments); THE REPORT OF THE PRESIDENT'S COMMISSION ON HOUSING 150-52 (1982) (recognizing the need to encourage the development and use of alternative mortgages).

2. *See generally*, M. Madison & J. Dwyer, THE LAW OF REAL ESTATE FINANCING (1981) [hereinafter Madison & Dwyer, REAL ESTATE] (provides current information on a wide variety of commercial lending practices including sale and lease back arrangements, joint ventures, and various equity participation agreements).

returns go added risks. The market adage "no risk - no return," (or "no return for no risk"), has somehow escaped the comprehension of many lenders, who want to share in the possibility of exceptional profits from a developers' real estate project but seem unwilling to recognize that the developer's potential for exceptional profits is in part a reward for taking on exceptional risks.

These risks fall into two major categories. The first involves market risks such as inflation or poor targeting of a real estate project to the demographics of an area. The second category of risk is non-market related. It includes the risks of ownership itself, which range from potential tort liability to risk of destruction of property by natural disaster. Key among new risks in this second category — and the focus of this article — is the potentially devastating impact of liability for clean up costs under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA").[3]

Under CERCLA, an otherwise economically sound and successful real estate development project can be financially suffocated by the discovery of an environmental problem. The owner of property found to be contaminated with hazardous waste faces a potential for tremendous liability. This article examines the question of when lenders undertaking equity participations should be considered owners of a property for purposes of imposing liability under CERCLA. The article first addresses the general rules of liability under CERCLA that could be applied to a lender of funds for real estate acquisition and development. Then the article explains the basic types of arrangements most often employed by lenders engaged in equity participations. Finally, the article will present a justification for making the general rules of liability under CERCLA applicable to lenders engaged in mortgage arrangements that attempt to capture ownership rates of return in addition to market returns on their activities.

II. CERCLA LIABILITY RULES[4]

CERCLA was enacted by Congress in 1980 in response to concerns over the improper handling and disposal of hazardous sub-

3. 42 U.S.C. §§ 9607-9657 (1982), *as amended by*, 42 U.S.C. §§ 9601-9675 (Supp. V 1987).

4. To date, much has been written about general liability rules under CERCLA. *See, e.g.*, Vollman, *Double Jeopardy: Lender Liability Under Superfund*, 16 REAL EST. L.J. 3 (1987);

stances.[5] At many locations throughout the country there were sites containing large quantities of hazardous substances that posed serious risks to the safety and health of the environment and the general public.[6] CERCLA was intended to control and reduce this risk by creating a regulatory scheme governing the use and disposal of such hazardous substances and by assigning responsibility for compliance with this regulatory scheme. In 1986 Congress passed the Superfund Amendments and Reauthorization Act ("SARA") [hereinafter included in cites to CERCLA] which complemented and expanded upon the earlier scheme.[7]

These congressional acts have impacted lenders by making hazardous contamination liability issues one of the most uncertain areas of a real estate transaction. The difficulty in assessing risk of liability under CERCLA arises from its extension of liability to parties who were not involved in actually placing hazardous contaminants on the site. CERCLA imposes liability broadly on "owners" or "operators" of a facility or a site that contains hazardous substances,[8] a formulation that lends itself to an expansive scope of liability. Any liability as an owner or operator extends to

Bleicher & Stonelake, *Caveat Emptor: The Impact of Superfund and Related Law on Real Estate Transactions*, 14 Env't Rep. (BNA) 10017 (1984); Cheek, *Site Owners of Liability Insurers: Who Should Pay for Cleaning Up Hazardous Waste?*, 8 VA. J. NAT. RES. L. 75 (1988); Note, *The Superfund Insurance Dilemma: Defining the Super Risks and Rights of Comprehensive General Liability Policies*, 21 IND. L. REV. 735 (1988). Therefore, this article will present only a brief sketch of the relevant liability rules.

5. *See id. See also* Grad, *A Legislative History of the Comprehensive Environmental Response, Compensation and Liability ("Superfund") Act of 1980*, 8 COLUM. J. ENVTL. L. 1 (1982); F. Grad, TREATISE ON ENVIRONMENTAL LAW, § 4A.04[2] (1981); H. REP. No. 1016, 96th Cong., 2d Sess. 1-21, *reprinted in* 1980 U.S. Code Cong. & Admin. News 6119, 6119-23.

6. *See*, H. REP. No. 1016, 96th Cong., 2d Sess. 17-21, *reprinted in* 1980 U.S. Cong. & Admin. News 6119, 6120-21. The Report indicated that the Hooker Chemical disposal sites in Niagara Falls, N.Y. contained as much as 352 million pounds of hazardous materials. *Id.* at 18, *reprinted in* 1980 U.S. Code Cong. & Admin. News, at 6121.

7. *See* 42 U.S.C. §§ 9601-9675 (Supp. V 1987).

8. *See* CERCLA § 107(a), 42 U.S.C. § 9607(a) (Supp. V 1987). The relevant part of the section is as follows:

(a) Covered persons: scope
Notwithstanding any other provision or rule of law, and subject only to the defenses set forth in subsection (b) of this section—
(1) the owner and operator of a vessel or a facility,
(2) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of,
(3) any person who by contract, agreement, or otherwise arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or en-

the acts and omissions of all employees, agents, and other authorized personnel.[9] The liability imposed is strict, hence an owner who has done nothing to the property other than take title to it can become liable for cleanup costs and damages.[10] In addition, when multiple parties can be identified as liable either as contaminators of the property or as owners or operators there is joint and several liability as between the parties.[11] This means the government can go for the "deep pocket" or the easiest target in pursuing a recovery under CERCLA. Such an approach gives maximum flexibility to the government while shifting to the defendant the burden and expense of tracking down other potential parties for indemnification or contribution.

While a defendant has the right to join other parties, to seek contribution, or to enforce an indemnification agreement, section 9607(e) provides that an indemnity or other related agreement cannot be used to avoid liability.[12] Thus, a party is fully liable

tity, at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances, and

(4) any person who accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance, shall be liable for—

(A) all costs of removal or remedial action incurred by the United States Government or a State or an Indian Tribe not inconsistent with the national contingency plan;

(B) any other necessary costs of response incurred by any other person consistent with the national contingency plan; and

(C) damages for injury to, destruction of, or loss of natural resources, including the reasonable costs of assessing such injury, destruction, or loss resulting from such a release. . . .

9. *See id.*

10. *See* Philadelphia v. Stepan Chemical Co., 544 F. Supp. 1135 (E.D. Pa. 1982); United States v. Reilly Tar & Chemical Corp., 546 F. Supp. 1100 (D.C. Minn. 1982); New York v. Shore Realty Corp., 759 F.2d 1032 (2d Cir. 1985). *See also* 42 U.S.C. § 9607(b) (setting forth the only defenses to liability under § 9607(a)). *See generally* Murphy, *The Impact of "Superfund" and Other Environmental Statutes on Commercial Lending and Investment Activities*, 41 BUS. LAW. 1133 (1986).

11. *See* Levitas & Hughes, *Hazardous Waste Issues in Real Estate Transactions*, 38 MERCER L. REV. 581, 593 (1987); United States v. A & F Materials Co., 578 F. Supp. 1249 (S.D. Ill. 1984).

12. 42 U.S.C. § 9607(e)(1) (1982).

(e) Indemnification, hold harmless, etc., agreements or conveyances; subrogation rights

(1) No indemnification, hold harmless, or similar agreement or conveyance shall be effective to transfer from the owner or operator of any vessel or facility or from any person who may be liable for a release or threat of release under this section, to any other person the liability imposed under this section. Nothing in this subsection shall

unless it has a valid defense under CERCLA. This regulatory approach serves to streamline litigation because the statutory liability issues are relatively straightforward, whereas complex indemnity and contract agreements between private parties often require difficult matters of proof.

Under CERCLA it is possible, for example, for an individual borrower who owns or owned a heavily contaminated site like New York's notorious Love Canal to become jointly and severally liable for the cleanup costs of the hazardous substances left by Hooker Chemical. Since CERCLA has retroactive application, it is irrelevant that the disposal of the hazardous substance may have been entirely legal when carried out by Hooker Chemical. Any subsequent owner of the property, as well as Hooker, could nevertheless be strictly liable for cleanup costs and damages.[13]

The scope of liability under CERCLA for "owners" and "operators" has been a matter of significant controversy and litigation. Among the parties that courts have held liable as owners or operators are the following: current property owners, even when their actions played no part in the contamination of the site;[14] owners that lease their property to lessees who contaminate the site;[15] lessees who actually cause the contamination;[16] lessees who sublease the property to sublessees who contaminate the site;[17] trustees acting on behalf of a trust;[18] stockholders and corporate officers of a company responsible for contaminating the site;[19] a parent corporation whose subsidiary contaminated the site;[20] a company that held legal title and control over the site for one hour as part of a real estate transaction;[21] a city that owned a landfill at which unlawful disposal was carried out in return for

bar any agreement to insure, hold harmless, or indemnify a party to such agreement for any liability under this section.

13. *See* Caldwell v. Gurley Refining Co., 755 F. 2d 645 (8th Cir. 1985); United States v. Shell Oil Co., 605 F. Supp. 1064 (D. Colo. 1985).

14. *See, e.g.*, New York v. Shore Realty Corp., 759 F.2d 1032 (2d Cir. 1985).

15. *See, e.g.*, United States v. Argent Corp., 21 Env't Rep. Cas. (BNA) 1354 (D.N.M. 1984).

16. *See, e.g.*, United States v. South Carolina Recycling and Disposal, Inc., 21 Env't Rep. Cas. (BNA) 1577 (D.S.C. 1984); Caldwell v. Gurley Refining Co., 755 F. 2d 645 (8th Cir. 1985).

17. *See, e.g.*, *South Carolina*, 21 Env't Rep. Cas. (BNA) at 1577.

18. *See, e.g.*, United States v. Cauffman, 21 Env't Rep. Cas. (BNA) 2167 (C.D. Cal. 1984).

19. *See, e.g.*, United States v. Mirabile, 23 Env't Rep. Cas. (BNA) 1511 (E.D. Pa. 1985).

20. *See, e.g.*, Wehner v. Syntex Agribusiness, Inc., 616 F. Supp. 27 (E.D. Mo. 1985).

21. *See, e.g.*, United States v. Carolawn Co., 14 Envtl. L. Rep. 20699 (Envtl. L. Inst.) (D.S.C. 1984).

bribes;[22] and, a lender who became an owner by virtue of a mortgage foreclosure.[23]

The one significant statutory defense to liability as an owner or operator is the innocent third party defense.[24] This ambiguous defense applies to a party that is an owner of property but is completely innocent of the contamination of the property and without knowledge of it. An innocent third party cannot, however, simply find bliss in ignorance but must take affirmative steps to inform itself about possible hazardous contamination at the site. A party seeking to invoke the innocent third party defense must prove: (1) it acquired the property *after* the introduction of the hazardous substance; (2) it had no part in creating the contamination; (3) it did not know and had no reason to know of any contamination; and (4) it exercised due care and took reasonable precautions against foreseeable acts and omissions of third parties that could have caused contamination of the site.[25]

There are no clear guidelines as to what actions will satisfy the requirements of due inquiry. Some simple precautionary steps that every party considering purchasing real estate or financing a purchase should take include soil tests, environmental site inspec-

22. *See, e.g.*, Philadelphia v. Stepan Chemical Co., 544 F. Supp. 1135 (E.D. Pa. 1982).

23. *See, e.g.*, United States v. Maryland Bank & Trust Co., 632 F. Supp. 573 (D. Md. 1986).

24. 42 U.S.C. § 9607(b)(3) (1982):

(b) Defenses

There shall be no liability under subsection (a) of this section for a person otherwise liable who can establish by a preponderance of the evidence that the release or threat of release of a hazardous substance and the damages resulting therefrom were caused solely by —

(1) an act of God;

(2) an act of war;

(3) an act or omission of a third party other than an employee or agent of the defendant, or than one whose act or omission occurs in connection with a contractual relationship, existing directly or indirectly, with the defendant (except where the sole contractual arrangement arises from a published tariff and acceptance for carriage by a common carrier by rail), if the defendant establishes by a preponderance of the evidence that (a) he exercised due care with respect to the hazardous substance concerned, taking into consideration the characteristics of such hazardous substance, in light of all relevant facts and circumstances, and (b) he took precautions against foreseeable acts or omissions of any such third party and the consequences that could foreseeably result from such acts or omissions; or (4) any combination of the foregoing paragraphs.

See also Hitt, *Desperately Seeking SARA: Preserving the Innocent Landowner Defense to Superfund Liability*, 18 REAL EST. L.J. 3 (1989).

25. *See* Forte, *Environmental Liability Risk Management*, PROB. & PROP. 57-61 (Jan./Feb. 1989).

tions, aerial overviews of surrounding property, a title search, and an historical search concerning past owners and uses of the property that might provide clues about the presence of any hazardous substances.[26] In doing such a search the party should bear in mind that chemical and heavy industrial facilities are not the only typical sources of or clues to hazardous contamination problems. The development of vacant land, for example, can present contamination problems arising from prior use and disposal of agricultural chemicals used in farming operations.

Since these precautionary efforts are expensive the question of which party to a transaction should bear the costs arises. If a lender is involved in the transaction it should, for its own sake, assure itself that the proper precautionary steps are taken and should make the costs a part of the charge for the loan.

There are three reasons why a lender should try to assure itself that the proper precautionary steps are taken before closing. First, a proper environmental survey of the property is a first step in gathering relevant information about the value of a property as loan collateral. A negative report allows the lender to avoid entering an unwise mortgage relationship. Second, a lender who requires due inquiry reduces its lending risk because a borrower that can claim the innocent third party defense if the property is later found to be contaminated will have greater assets available to pay off its promissory note if the property is later found to be contaminated. The borrower with an innocent third party defense avoids CERCLA cleanup costs and damages and thus will not have those expenses to confront in addition to paying off obligations under its promissory note. Third, the lender may itself become liable as an owner or operator of the property in the future if it is forced to foreclose or take over management of the property. In that event, the lender, in order to assert an innocent third party defense, will want to have records of its due diligence with respect to the property from the time of the initial loan, as well as any subsequent investigations that might be appropriate. Thus, the third reason for a lender to obtain relevant environmental information about a property before making a loan, relates to the focus of this article: namely, when a lender should be considered an owner or operator under CERCLA.

26. *Id.*

III. EQUITY PARTICIPATION ARRANGEMENTS

Equity participations can come in many forms but they all have the underlying objective of providing a lender with an enhanced return on its investment by means of an equity stake in a project. The participation in equity is a speculative return taken by the lender in addition to the return it will receive from charging interest on the loan. The best way to understand the equity participation arrangement is to compare it to the standard or traditional mortgage relationship, and then to explore the motivation and methods for deviating from that traditional relationship by use of equity participation arrangements.

In the traditional mortgage relationship, the lender, as mortagee, makes money available to the borrower/mortgagor and charges interest. The borrower pays the lender back the principal of the loan and interest on a payment schedule that results in the full satisfaction of the debt and the discharge of the borrower's obligation. In this traditional mortgage relationship, the lender looks upon the making of loans as the investment of funds in return for interest payments which, over the expected life of the loan, provide a competitive rate of return relative to other investment opportunities available to the lender. The interest rate charged by the lender has to provide the market rate of return for the use of money - the real rate of return - and, in addition, be sufficiently high to cover the rate of inflation expected to occur over the life of the loan.

The same basic approach to lending and interest rates applies when lenders use adjustable rate mortgages, which tie the interest rate to various indices to make it more responsive to inflationary pressures during the loan term. Adjustable rate mortgages differ from traditional mortgages in that they shift at least part, if not all, of the inflationary risk to the borrower. Whereas the long-term fixed rate mortgage can prove to be a bad investment if the initial interest rate does not adequately anticipate future inflation, the adjustable rate mortgage allows for action to correct for departures from expected inflation. Thus, the adjustable rate mortgage became particularly attractive after many institutional lenders suffered tremendous losses in the late 1970's and early 1980's as a result of being locked into interest rates during a highly inflationary period. While inflation moved market rates to

15-20%, fixed rate mortgages were frozen at the 8-9% level.[27] The adjustable rate mortgage results in a more predictable rate of return on lending activities. In the final analysis, however, the adjustable rate mortgage, like the fixed rate mortgage, provides for lending profitability generated only by the interest charge and any additional borrower fees or expenses that may be required for originating or servicing the loan.

In the profit-squeezed years of the late 1970's and early 1980's, lenders became receptive to creative methods of adding to their profitability. They also became increasingly aware of the large profits that many of their real estate developer borrowers were making as a result of the rising value of well situated real estate projects. Pressured to enhance their profitability and observing the potential for profit from real estate development, many lenders became interested in structuring their loan arrangements so as to include an equitable interest for themselves.

The equity interest or so called "equity-kicker" required by equity participation loans provides the lender with the potential for a return on its loan investment over and above its traditional source of interest revenue by allowing the lender to share in the success of the borrower's real estate project. The following are representative equity participation transactions: the mortgage coupled with a joint venture; the shared appreciation mortgage; the mortgage coupled with a ground lease; the mortgage coupled with a participation in long-term project income flow; and the convertible mortgage.

The mortgage coupled with a joint venture is unique among equity participations in that it openly places the lender in the position of being a co-developer of the project.[28] In conjunction with the standard mortgage relationship between the parties, the

27. *See* Malloy, *The Secondary Mortgage Market — A Catalyst for Change in Real Estate Transactions*, 39 SOUTHWESTERN L.J. 991, 995-1000 (1986) [hereinafter Malloy, SECONDARY MORTGAGE MARKET]. Lenders were losing money because their cost of funds exceeded their return on loan portfolio investments. This was due in part to regulations restricting the type of mortgages that could be used by lenders and to restrictions on interest rates that could be paid to depositors. Because depositors could only be paid around 5% on their savings, many depositors shifted their savings to money market funds that were paying 15-20% interest. This disintermediation left lenders trying to borrow in high cost short-term markets while holding long-term fixed rate mortgage debt at below current market rates. *See also* Madison & Dwyer, REAL ESTATE, *supra* note 2, at ¶ 2.01(1)-(3), 2.02(3)(a)-(d) (Supp. 1989).

28. *See generally* Madison & Dwyer, REAL ESTATE, *supra* note 2, at ¶ 11 (discussing entity selection pursuant to loan participations and joint ventures).

lender enters into a joint venture agreement that typically allows it to share jointly in the return from the project, while having minimal or no authority or responsibility for project management beyond that which is normally exercised by a lender in overseeing or supervising its loans.

The shared appreciation mortgage, which has gained acceptance in the residential mortgage markets as well as in the commercial real estate mortgage market, allows the lender to share in the equity appreciation of the project.[29] This can be accomplished by an express provision in the loan giving the lender a fixed share in any measurable appreciation in the property. For instance, a lender may be given a 30% interest in equity appreciation, in addition to interest on the loan. The lender's share in the equity appreciation may be payable at the time of the sale of the property, at the time the loan is paid off, or at the end of a stated time period from the date of the loan.

The shared appreciation mortgage arrangement requires the borrower and lender to agree on the method of future valuation of the property in order that the equity appreciation and the lender's share therein can be determined. This is a task which is obviously made more difficult when there is no sale of the property or if the borrower has made substantial improvements to the property making it difficult to distinguish between increases in value due to equity appreciation of the property in its original form and increased valuation due to other factors. The difficult, yet solvable, problems of valuation and timing aside, however, it is apparent that the lender, in addition to being a mere passive lender of funds, becomes an equity owner of the property through this mortgage arrangement. Though this ownership interest is less salient than that present in the mortgage coupled with a joint venture, it nevertheless opens the lender up to liabilities incident to ownership.

A more complicated method of equity participation involves the coupling of a groundlease interest to the mortgage relationship.[30] In such an arrangement, usually undertaken in a commercial transaction, a project like a shopping center is structured as a long-term groundlease. The developer is the groundlessee and operator of the shopping center and undertakes liability on a

29. *See generally* Nelson & Whitman, FINANCE, *supra* note 1, at 792-4.

30. *See generally* Madison & Dwyer, REAL ESTATE, note 2, at ¶ 6 (discussing and giving examples of and references for leasehold and leaseback).

leasehold mortgage. As part of the deal the lender provides the leasehold mortgage funding and is the landlord on the long-term groundlease. The groundlease is a "triple net" lease, relieving the lender of any of the insurance, tax, or other such obligations of ownership, while at the same time providing it with the ability to collect a ground rent from the developer. The lender thus captures (1) a share of the appreciation of the real estate project through periodic rent adjustments based on increased valuation; (2) a share of the income flow of the project through linking rent adjustments to increases in subtenant sales revenue; and, (3) a cushion from inflationary impacts by further adjusting ground rent based on periodic changes in the Consumer Price Index (CPI) or some other market indicator.

As a groundlessor, the lender makes itself legal owner of a recognizable interest in the property. To that extent, it opens itself up to legal challenges and liabilities that are among the incidental risks of ownership. The typical groundlease requires the developer to indemnify or protect the lender from any such liability, but there are limits — explored below — to the extent to which a lender can contract out of ownership risk and liability.

Another form of equity participation is the use of a mortgage coupled with a percentage share in the long-term income flow of the project.[31] This arrangement is frequently used when the borrower is the developer of a shopping center or an office building. In the common scenario, the lender collects interest on the loan and takes, in addition, a percentage of the net or gross income flow from tenant leases, and/or sales, generated at the project location. In this way the lender shares in the success of the project by getting a share in rising rent roles or sales which rise with either an increase in inflation or with the increased desirability of the real estate location.

Through this arrangement, the lender, though not directly an owner of the property, shares indirectly in some of the benefits of ownership. If the project over time experiences equity appreciation, the developer will be able to charge higher rents to tenants and increase its income from the project. Indirectly, the benefits of ownership are passed on to the lender to the extent that the lender shares a percentage of the rent role income. Likewise, the

31. *See id.* at ¶¶ 3.04, 8.08, and Appendix B, Form 6.2. Form 6.2 illustrates a groundlease coupled with a percentage of rent role or sales on the premises.

income-share mortgage arrangement also provides a hedge against inflation and general market risk because a rise in the inflation rate results in higher rent roles and higher sales prices of items in retail stores, hence higher income flows.

A key difference between this arrangement and other types of equity participation is that, as a consequence of having no direct equity ownership rights, the lender has no means of capturing an owner's return if the property becomes highly valued for a new and different use. A distinct feature of ownership of a real estate project is the ability to capture an increased valuation of the property even if the increased value requires that the property be put to a new or different use. For example, at the time at which the mortgage agreement is made, a property may be suitable for a medium-size shopping center. Then, years later, as the result of a large influx of population and the construction of larger and more modern shopping facilities, the property might be more valuable if it were used for high density housing. In such a situation, the owner-developer captures the full value of the change of use. The lender, on the other hand, does not share in these returns to ownership. Likewise, if the property were to be condemned or be the subject of a high-priced private buy-out, the owner would capture these returns to ownership and the lender would not. As a result, other forms of equity participation mortgages that give a lender a share of direct ownership provide a greater potential return to the lender than does the mortgage coupled with a percentage return on income flow from the project.

A middle-ground approach used by some lenders involves the use of the convertible mortgage as a means of achieving the benefits of equity participation while avoiding exposure to the potential liability risks of ownership.[32] The convertible mortgage establishes the traditional mortgage relationship between the lender and the borrower but expressly provides for the exercise of a conversion option by the lender at established intervals during the life of the loan. The mortgage terms may, for instance, give the lender an option exercisable at the end of years 3, 5, 7, and 10 of the loan. The exercise of the option allows the lender to convert, in whole or in part, from its position as lender to a position as owner, based on a prearranged formula for valuing

32. *See id.* at ¶ 3.04 (3)(a) and (18). *See also* Timmons, *A Computer-Based Model for Evaluating Convertible Mortgages*, 6 REAL EST. FIN. 46 (1989).

the conversion. In such an arrangement, the lender can be expected to exercise its options if the project has done well in the marketplace. Thus, the lender, while not holding an ownership interest from the outset, is able to capture the advantages of ownership return by exercising its conversion option.

While equity participations can take many forms, the primary variations have been outlined above. It is clear from these illustrations that each type of arrangement is designed to enhance the lender's rate of return on its lending activities by allowing it to share the ownership interest in a real estate project. To what extent should reciept of the benefits of ownership-related profits come at the expense of added ownership liability, particularly ownership liability under CERCLA?

IV. Justifications for Lender Liability Under CERCLA

Lenders have been found vulnerable to CERCLA liability when they become the outright owners of real property through the process of foreclosure or exercise managerial control over the property. In *United States v. Maryland Bank & Trust Co.*, the court held that a lender that takes property at foreclosure becomes liable as an owner or operator under CERCLA.[33] Presumably the same consequences follow if a lender becomes the owner of property by virtue of a deed in lieu of foreclosure. Likewise, in *United States v. Mirabile*, the court found that a lender could be liable as an owner or operator if it exercised managerial control over the property or over a debtor's activities on the property.[34] This result is consistent with earlier court holdings in other areas of federal regulation of real estate, such as under the Interstate Land Sales Full Disclosure Act and the Securities Act.[35]

33. *See* United States v. Maryland Bank & Trust Co., 632 F. Supp. 573 (D. Md. 1986).

34. *See* United States v. Mirabile, 23 Env't Rep. Cas. (BNA) 1511 (E.D. Pa. 1985).

The same understanding of lender liability was articulated in the recent case United States v. Fleet Factors Corp., 29 Env't Rep. Cas. (BNA) 1011 (S.D. Ga. 1988). The lender in *Fleet Factors* was found not to be liable because it had never exercised managerial control or held an ownership interest during the relevant time period. *See also* Polger v. Republic National Bank, No. 88-C-295 (D. Colo. Mar. 1, 1989) (if lessee could be held liable to its lessor for CERCLA violations, lender which forecloses on lessee's operation is also potentially liable).

35. *See generally* Malloy, *The Interstate Land Sales Full Disclosure Act: Its Requirements, Consequences, and Implications for Persons Participating in Real Estate Development*, 24 B. C. L. Rev. 1187 (1983) (potential liability under ILSFDA if lender can be characterized as a developer, agent, aider or abettor); Malloy, *Lender Liability for Negligent Real Estate Appraisals*,

One question that remains unanswered after *Maryland Bank* and *Mirabile* is whether acts by a lender that fall short of taking actual title or exercising managerial control over property should lead to ownership liability.[36] When should making a loan make a lender liable as an owner or operator under CERCLA? Merely acting as a passive lender of funds, as in the prior tradition of banking, should not make a lender an owner or operator. The traditional making of a loan in return for interest should pose no risk of lender liability under CERCLA unless either the *Maryland Bank* (ownership by foreclosure) or *Mirabile* (exercising managerial control) circumstances obtain. But in today's mortgage markets many lenders are electing to make more creative and aggressive mortgage arrangements, including a wide range of equity participation loans. How should these equity participation mortgages be treated under CERCLA?

A starting point for considering lender liability under CERCLA for equity participation loans is to look at the nature of the loan itself. If the loan seeks merely to protect the lender from market risks, then it should not be considered grounds for lender liability under CERCLA. On the other hand, if the equity participation loan is structured in such a way that it includes a return to an ownership interest, then the lender should be held jointly and severally liable as an owner or operator under CERCLA.

A. *Distinguishing Market Risks from Ownership Risks*

Ownership risk is different from market risk. The market involves, by definition, many participants, with no one participant having the power to dictate terms or prices. All buyers and sellers take their prices from the market. If corn is selling at $5 a bushel a seller who wants to sell corn at $20 a bushel will not sell any

1984 U. ILL. L. REV. 53, 95-96 (ability to recover from lender for negligent preparation or use of a real estate appraisal).

36. For discussions of other issues raised by *Maryland Bank* and *Mirabile*, *see, e.g.*, Rashby, *United States v. Maryland Bank & Trust Co.: Lender Liability Under CERCLA*, 14 ECOLOGY L.Q. 569 (1987) (third party defenses in relation to *Maryland Bank*); Klotz & Siakotos, *Lender Liability Under Federal and State Environmental Law: Of Deep Pockets, Debt Defeat and Deadbeats*, 92 COM. LAW 275 (1987) (guidelines for avoiding risks); Cohen, *Hazardous Waste: A Threat to the Lender's Environment*, 19 U.C.C. L.J. 99 (1986) (same); Forte, *Environmental Liability Risk Management*, PROB. & PROP. 57 (Jan./Feb. 1989) (same); Murphy, *The Impact of "Superfund" and Other Environmental Statutes on Commercial Lending and Investment Activities*, 41 BUS. LAW. 1133 (1986) (general discussion of risks for lenders in this area); Hawley, *Introduction to Lender Liability*, ALA. LAW. 212 (July 1987) (same).

corn. The value of a seller's corn is determined by impersonal market forces.

In contrast to market risk, ownership risk is more personal. Corn may be selling at $5 a bushel in a given season, but if there was no rain for nine months in a particular seller's county, that seller has no corn to sell. Or, housing prices may be on the rise, but a particular seller's house is destroyed by fire and unsaleable. These examples illustrate the independence of ownership and market risks.[37]

The independence of these risks in the real estate market should not be exaggerated. In a declining housing market, for example, though ownership is highly risky, market risks may be negligible because of the use of adjustable rate mortgages. Yet a lender is nevertheless not completely free of the consequences of ownership risk because a seriously depressed real estate market might experience higher mortgage default rates. At the same time, the lender, in many jurisdictions, has the right to a personal deficiency judgment on the promissory note against a defaulting borrower and is therefore not fully dependent for repayment on the value of the property. In general, moreover, the risk of mortgage default and the hedging of that risk are business risks for the lender and as such they remain fundamentally separate and apart from ownership risk.

B. *Ownership Risks and CERCLA Liability*

A potentially higher rate of return is provided to an ownership interest because ownership implies added risk and responsibility. These risks include potential tort or contract liability as well as risks associated with entrepreneurial acts, such as positioning the real estate investment in the market and applying personal insight or talent to make something more of the ownership interest than could other market participants. As a return for these risks of ownership, the borrower has a right to any equity appreciation in his or her home or other real estate investment.

37. A clear example of this distinction is evident in the housing market in New Orleans. As a result of prolonged economic devastation resulting from the bust in the oil and gas markets, New Orleans housing prices have dropped over the last few years. While property owners have taken a bath, home mortgage rates have remained relatively stable because the market for home mortgages extends beyond the economically depressed area. Consequently, lenders with adjustable rate mortgages continue to enjoy some hedge against risks while it is the property owners that are suffering the brunt of the ownership risk.

The lender that is in the business of making loans is primarily concerned with earning a proper return on that money, which of course includes the concern that it in fact be repaid. Mortgage security law, adjustable rate mortgages, and other mortgage market instruments are addressed to this concern. The lender that seeks an equity participation mortgage, on the other hand, seeks a share of ownership, a share of the potential return to ownership risk. But, if the old saying is true — "no risk, no return," then the corollary "no return, if no risk" should also be true. A lender that seeks a return on equity should in turn be liable for the risks of ownership. Nothing requires a lender to take an equitable interest as part of a loan transaction and the lender that does so should bear the risk that goes hand in hand with the potential profitability of ownership.

Many of these risks of liability might be bargained about between the borrower and lender. The lender can provide that the borrower is responsible for tort liability insurance for any injuries on the property, or that the borrower will indemnify the lender if it is sued in a tort action. Under CERCLA, however, an owner or operator cannot avoid joint and several liability by merely trying to shift risk in underlying individual agreements.[38] A lender, as an equity owner, would and should be liable without regard to any underlying indemnification agreement or other contractual arrangement. An equity participation loan makes a lender an owner by definition, even if that share of equity is only a small percentage. Thus, lenders that make equity participation loans should be jointly and severally liable for cleanup costs and damages under CERCLA.

Most of the varieties of equity participation loans described above are clearly loan arrangements that should lead to direct lender liability under CERCLA. Shared appreciation mortgages, joint ventures, and groundlease mortgage tie-ins are all designed to provide lenders with the benefits of ownership return in addition to a market return and hedge against the lender's financing activities.

The two types of equity appreciation loans that less clearly involve ownership are the mortgage with a percentage of the income generated at a commercial real estate site and the mortgage

38. *See* 42 U.S.C. § 9607(e) (1982).

with options to convert to or acquire an equity stake. These two equity participations must therefore be examined more closely.

The loan that provides for an interest return plus a percentage share in either rent revenue or on-site sales is a hybrid arrangement. On the one hand, it provides the lender with a return related to the ownership interest. That is, a successful shopping mall or office building should see rising sales and rent revenue because of the desirability of the project itself. By virtue of the percentage tie-in arrangement, the lender shares in this return. On the other hand, the lender does not share in the added value or appreciation of the ownership interest if the property is put to another use. Yet, though there arguably is a significant element of ownership missing in the lender's relationship to the property, this element should not be considered sufficient to allow the lender to avoid liability under CERCLA.

The convertible loan option is also less than a traditional ownership interest. Under this loan arrangement, the lender can typically convert part of its lender position to an equity position at a future date. Obviously if the project is a success and is appreciating a great deal, the lender will be tempted to convert its position. This right should be considered a sufficient ownership interest to impose CERCLA liability since the lender is entitled to capture part of any increase in value related to ownership risk.

The exception to this is where the option to convert is exercisable at fair market value, or at an increasing price that resembles fair market value, during the term of the loan. In such a setting, the lender is simply given a privileged position in terms of the right to buy out the owner's return rather than capturing the appreciated value of ownership.

C. *Policy Implications of Imposing CERCLA Liability on Lenders Engaged in Equity Participations*

Since CERCLA liability can be extremely burdensome, it is necessary to explore the policy implications of imposing it on lenders. On the one hand, it may seem unwise to impose this added financial risk on lending institutions, especially at a time when so many institutions are suffering losses from bad debt, third world debt, mismanagement, and insolvency. On the other hand, lending institutions should be confronted with the information necessary for them to make proper financial decisions about ownership. The law should not pretend a lender is not an owner or operator

of property when it is. Lenders need to diversify their activities and control their risk exposure - a lesson many savings and loans, and now taxpayers, are learning the hard way.

There is also a practical social reason for not letting lenders escape owner or operator liability under CERCLA. Most real estate transactions involve borrowed money, and this creates an ideal opportunity to make strides at cleaning up the environment. When borrowers and lenders work out the terms for financing a real estate transaction, they go through a long checklist of requirements, especially in the case of commercial real estate transactions. These requirements include title examination, surveys, zoning and use considerations, and endless documentation. Information relating to hazardous waste contamination could easily be added to this list. Many good real estate lenders have already included significant environmental requirements in their loan documentation.

The lender, as the financial intermediary between savers (depositors) and borrowers, holds a unique position of control over the exchange of funds and could use this position to further the desirable social goals of CERCLA. Lenders have previously spared no end in the types of terms and agreements they are willing and able to extract from commercial real estate developers. Furthermore, as is the case with title insurers and surveyors, lenders have occasion to deal with environmental specialists on a continuing basis, whereas borrowers may have rare or one-time needs for borrowed funds. Thus, the lender is in a better position to learn about the environmental services that are available than the borrower in many transactions.

Finally, the lender can diversify its risk. Through alternative financial activities and by way of the secondary mortgage market for real estate loans, the lender, unlike the typical borrower, is able to spread the risk of individual transactions across diverse pools of mortgages and across geographic boundary lines.[39]

If lenders find that equity participation loans are too risky when directly linked to CERCLA liability, they can make other types of loans or merely adjust the market rates charged for funds in non-equity transactions. Taxpayers should not be funding or subsidizing high-risk ownership returns for lenders. If CERCLA liability jeopardizes the profitability of lending institutions, Congress

39. *See* Malloy, *Secondary Mortgage Market*, *supra* note 26, at 1013-1020.

and the public need to debate the wisdom of continued liability directly. At least until Congress indicates otherwise, lenders should be treated no differently from other owners, and their interest in equity participations should result in liability under CERCLA.

V. Conclusion

The real estate transactions environment, like the natural environment, has changed. Real estate lawyers and their clients in real estate transactions need to be aware of all the potential risks as well as the potential returns from a real estate venture. This article has focused on one particular trend in real estate financing: the use of the equity participation loan.

Such loans help lenders diversify their investment portfolios and provide new avenues for potentially highly profitable activities. Unlike adjustable rate mortgages and other types of loans that help reduce market risk to the lender, the equity participation mortgage provides the lender with a return for an ownership risk in the property. This article separates mortgage financing arrangements into those that provide a return to market risk and those that provide a return to ownership risk, and argues that the two types of arrangements should be treated differently for purposes of imposing CERCLA liability. Equity participation loans, unlike other loans, should make a lender an owner or operator under CERCLA and thereby directly subject it to liability for cleanup costs and damages.