Analysis&Perspective

Enactment of the Federal Lender Liability Amendments may have reduced concern by some lenders over potential environmental liability. That is not necessarily a wise course, Larry Schnapf writes in this article. A review of lender liability cases from 2000 shows the different factual scenarios that exposed lenders to financial liability for cleaning up contaminated properties.

Year 2000 Review of Lender Liability Under Environmental Statutes

BY LARRY SCHNAPF

Since the enactment of the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 in 1996 and state lender liability laws, many financial institutions have become less concerned about potential environmental liability. Indeed, with Wall Street increasingly competing with traditional lenders for loans, many banks have relaxed their due diligence requirements. However, lenders are continuing to find themselves embroiled in disputes over responsibility for environmental contamination. This article will review some of the recent lender liability cases.

Overview of Lender Liability. The principal federal environmental laws of concern to financial institutions have been the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)[1] and the Resource Conservation and Recovery Act (RCRA).[2] Most states have enacted versions of these statutes.

CERCLA imposes strict and joint liability on four classes of potentially responsible parties (PRPs) for the cleanup and reimbursement of costs associated with releases of hazardous substances. The four classes of PRPs include past and current owners of facilities and vessels (i.e., tanks, equipment, etc.), past and current operators of facilities and vessels, generators of hazardous substances, and transporters of hazardous substances.

The definition of "owner or operator" does contain a secured creditor's exclusion, which states that any person who "holds indicia of ownership primarily to protect his security interest" in a vessel or facility will not be liable as an owner or operator if that person does not "participate in the management" of the facility or vessel. EPA issued a CERCLA Lender Liability Rule in 1992,[3] but a federal appellate court vacated the rule in 1994.[4]

RCRA regulates the generation, storage, handling, transportation and disposal of hazardous waste. Owners or operators of RCRA-regulated facilities must comply with certain operating standards and are also required to undertake corrective action to cleanup contamination caused by hazardous or solid wastes.

RCRA contains a secured creditor's exemption similar to the CERCLA provision, except that it is limited to underground storage tanks (USTs). The RCRA secured creditor's exemption provides that a lender who has indicia of ownership in a UST system (i.e., one or more USTs) or property containing a UST system will not be liable as an owner or operator of the UST system if: (i) the indicia of ownership is held primarily to protect a security interest; (ii) the lender does not participate in the management of the UST system, and; (iii) the lender is not engaged in petroleum production, refining or marketing (42 U.S.C. 6991(b)(h)(9)). The EPA issued a RCRA Lender Liability Rule interpreting the scope of the RCRA secured creditor's exemption in 1995.[5]

The Lender Liability Amendments added new provisions to the CERCLA and RCRA secured creditor exemptions and codified the provisions of the two EPA lender liability rules. Those regulations essentially provided that a lender must exercise actual day-to-day control over a borrower's operation before it will be considered "participating in the management of a facility." Moreover, lenders were allowed to foreclose on property without becoming liable as an owner so long as they expeditiously took steps to sell the property and comply with environmental laws while they were in possession of the property.

[1] 42 U.S.C. 9601 et seq.
[2] 42 U.S.C. 6901 et seq.
[3] 57 FR 18344 (April 29, 1992).
[4] Kelley v. EPA, 15 F.3d 1100 (D.C. Cir. 1994).
[5] 60 FR 46698 (September 7, 1995).

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quished possession of unsold inventory back to their borrowers. However, EPA has consistently taken the position that such action constitutes abandonment of hazardous wastes when the borrower is insolvent and creates generator liability for the lender.

By taking control of the site, a lender may also be unwittingly asserting control over the USTs and expose itself to a claim from the landlord. Such claims are most likely when there are environmental covenants imposing obligations on the borrower or where the borrower had the right to use or control the USTs under its lease.

Banks should consult with environmental counsel before taking possession of a former borrower's facility or conducting an auction at a manufacturing facility.

As a result, financial institutions should consult with environmental counsel prior to taking possession of a former borrower's facility or conducting any auction at a manufacturing facility. It would be advisable for lenders to retain an environmental consultant or environmental attorney to inspect the facility prior to taking control in order to evaluate the possible environmental liabilities that might be associated with the auction.

In addition, the lender should have its counsel review both the lease and the state UST registrations to determine who is responsible for the USTs. If the USTs are registered in the name of the borrower, the lender should discuss the status of the USTs with the landlord. If the owner believes that the USTs enhance the marketability of the site, the lender may be in a good position to negotiate a satisfactory resolution to the UST issue prior to assuming control of the site for the purpose of conducting an auction of the former borrower's assets.

Another practice that can expose a lender to liability is hiring guards. Lenders frequently hire a guard to protect inventory or equipment until an auction can be conducted. The guard often is posted at the entrance to the plant and will not allow access to the property without approval of the lender. There have been occasions when the lender's guard denied access to a local government inspector who wanted to confirm that the abandonment of the facility did not pose a risk of danger or explosion. By exercising such control over a facility, a lender could be deemed to be an operator of the facility and be held responsible for remediating environmental problems at the site. To minimize this possibility, a lender should have its guard posted in or outside the building where the collateral is located instead of at the gate leading to the entire facility.

The lender may also want to have an environmental consultant present at the auction to make sure that hazardous materials remaining at the property are not disturbed or spilled. If any materials are inadvertently spilled, the consultant could take immediate steps to contain and clean up the spill and document those actions.

Lender Common Law Liability for Petroleum Spills. The Federal Lender Liability Amendments do not provide relief from claims brought under state environmental and common laws. The limited nature of the protection offered by these provisions was recently illustrated in a Maryland state court decision.

In *Edwards v. First National Bank of North East,*[6] plaintiff, who was the owner of a gasoline station/mini-market, defaulted on its mortgage. The defendant bank foreclosed on the property and after it acquired title, the bank performed a tightness test on three underground storage tanks (USTs) that were located on the property. The USTs passed the tightness test and the bank/defendant then arranged with a local contractor to remove the USTs. A representative of the Maryland Department of the Environment (MDE) was present during the UST removal. Petroleum odors were detected during the tank removal and post-excavation samples confirmed the presence of concentrations of petroleum above the MDE cleanup levels. Presumably, the contamination was from older tanks that had been replaced. The MDE then arranged for the installation of three groundwater-monitoring wells, which detected petroleum in the groundwater.

Meanwhile, the defaulted borrowers also operated a day care center from their home which was located near the former mini-market. Several weeks prior to the UST excavation the borrowers had installed a drinking water well on their property to comply with local health code requirements governing day care centers. One month after the well had been installed, the plaintiff/borrower began to smell gasoline in their house. When the odor intensified, they had the well water sampled, which confirmed the presence of petroleum in their drinking water. The plaintiff/borrowers then filed suit for injury to their real and personal property. They filed common law claims for negligence, trespass, nuisance and strict liability and also filed a claim under the state Water Pollution Control and Abatement Act (the Act).

The defendant bank argued that the secured creditor exemption excluded lenders from the definition of persons who could be responsible for a discharge. The exemption provided, in part, that a person who holds indicia of ownership primarily to protect its security interest and does not participate in the management of a facility would not be a person responsible for a discharge if it abandons a UST in accordance with the MDE requirements within six months of acquiring title through foreclosure or other means.

The exemption also provided that a creditor who acquires title through foreclosure to a property that is subject to a corrective action plan approved by the MDE or who extends credit to perform remedial actions pursuant to MDE requirements would also not be considered a person responsible for the discharge. Moreover, a creditor who takes actions to stabilize contain or prevent a discharge in a manner that does not cause or contribute to a discharge also shall not be responsible for a discharge provided that the lender (i) furnished advance notice of the action to the MDE; (ii) would not be considered responsible for the discharge prior to the remedial action, and (iii) the lender's actions did not violate the statute. Finally, the secured creditor's exemption also limited a lender's liability to the costs to respond to the discharge caused by the lender.

[6] 712 A.2d 33, 122 Md. App. 96 (Ct. Spec. App. 1998).

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Since the defendant bank had complied with the foregoing requirements by removing the USTs within 180 days of foreclosure, the bank argued it was immune from any environmental liability at the site. The trial court agreed and held that the secured creditor's exemption abrogated all common law claims arising out of petroleum contamination at the adjacent property that originated from the mini-market property.

However, a state appellate court reversed the dismissal. The appellate court held that the secured creditor's exemption did not confer a blanket immunity on the bank but was limited to determining when the bank could be held statutorily liable as a "person responsible for the discharge." In so holding, the court relied on language elsewhere in the Act, which indicated that the statutory rights and remedies might not be construed to abridge or alter rights or remedies under existing common law or other statutes. In addition, the court said that the state constitution contained a presumption against statutory preemption of common law rights and that there was no express or implied legislative intent to abrogate or preempt common law claims.

Some state lender liability statutes expressly protect lenders against common law claims, others do not. Lenders, therefore, need to familiarize themselves with the scope and requirements of state statutes before foreclosing on property.

The bank contended that such a narrow reading of the secured creditor's exemption would render it superfluous. However, the court responded that the exemption insulated lenders from claims for cleanup costs brought by the MDE. The case was remanded to the trial court for a hearing on the merits of the common law claims.

Over two dozen states have enacted their own lender liability statutes or promulgated lender liability regulations that may differ from the federal law. While some state lender liability statutes expressly protect lenders against common law claims, others—as we have seen—do not confer such protection. Consequently, lenders need to familiarize themselves with the scope and requirements of these state statutes before determining whether to foreclose on property.

No Owner/Operator of Superfund Site. The Federal Lender Liability Amendments insulated a lender from CERCLA liability in *United States v. Pesses*.[7] In that case, Dollar Savings Bank (Dollar) entered into an industrial loan financing arrangement with the Lawrence County Industrial Development Authority (LCIDA) in 1975. Under this arrangement, the LCIDA acquired a site for development and entered into a 15-year lease-purchase agreement with Metcoa which had agreed to develop the site. Between December 1975 and November 1978, Dollar and two other banks made three loans to LCIDA totaling $916,000. The LCIDA distributed the proceeds of these loans to Metcoa which used the funds to purchase machinery and equipment and to build a plant. LCIDA assigned its right to the rental payments to Dollar, which it applied to pay down the loan. In addition, Dollar took back chattel mortgages on the machinery and equipment and a mortgage on the property.

When Metcoa defaulted on its July1983 rental payment, Dollar declared a default. Metcoa was forced into Chapter 7 bankruptcy and the bankruptcy trustee assumed Metcoa's rights under the lease while title remained with LCIDA. Dollar attempted to find a new tenant to take over the property and listed the property with several real estate brokers. In November 1983, the bankruptcy trustee auctioned off Metcoa's inventory and equipment. Several parties inquired about the property but it was not until October 1984 that Dollar was able to lease a portion of the property to a sailboat manufacturer who wanted to use the site as a storage facility. This leasing arrangement lasted until July 1985 and resulted in only minimal rent payments.

In December 1984, a representative of the Nuclear Regulatory Commission (NRC) inspected the site and discovered low-level radioactive materials. The NRC told Dollar it could not market the site without an NRC survey certifying that the site was clean. After contacting the state Department of Environmental Resources (DER), Dollar retained a consultant to determine the extent of contamination at the site. In October 1985, the consultant issued a report recommending that a comprehensive site investigation be performed to determine the cleanup costs. When Dollar realized that the cleanup costs exceeded the loan balance and the property value, the bank returned the keys to the facility to the bankruptcy trustee.

In 1986, EPA commenced a site investigation and removed over three thousand drums of hazardous materials. In 1990, the agency filed a cost recovery action against over two dozen parties who had sent waste to the site. These parties, in turn, filed contribution actions against other potentially responsible parties, including Dollar.

Dollar continued to try to lease the site but potential tenants lost interest when they learned about the contamination and the lawsuit. Dollar's efforts were also hindered because EPA would not grant permission to interested parties to inspect the site. In 1997, Dollar did find one party who offered to purchase its liens for the value of the tax liens on the property, but this prospective purchaser could not obtain financing.

Plaintiffs conceded that Dollar had not arranged for the disposal of hazardous substances at the Metcoa site but alleged that Dollar was an owner or operator of the site. Without much analysis, the court concluded that Dollar had not participated in the management of the facility while the borrower was in possession of the site and that Dollar's efforts to re-lease or sell the property fell satisfied the requirements of the Federal Lender Liability Amendments.

In this case, Dollar made effective use of both the bankruptcy trustee and the industrial development authority to shield itself from liability. By having the LCIDA retain title to the land and the trustee assuming control over the property, Dollar was able to maintain a tenuous connection to the site while still playing an active role in trying to sell or re-lease the property. Moreover, the opinion reported that some drums were knocked over or had deteriorated following the bank-

[7] 1998 U.S. Dist. Lexis 7902 (No.-90-0654, May 6, 1998).

ruptcy trustee's sale of the inventory and equipment. Banks in the past have been found liable as operators of a facility under such circumstances. However, since the bankruptcy trustee was managing the site instead of an auctioneer hired by the bank, Dollar avoided liability in this case.

Another interesting aspect of the case is that the court retroactively applied the Federal Lender Liability Amendments to actions taken by the bank in the 1980s and early 1990s. At that time, there was no "bright-line" test for judging a bank's post-foreclosure actions. The court nevertheless concluded that no prospective bidder had made a bona fide offer for the property even though the standard for judging whether an offer was bona fide did not exist until EPA promulgated its lender liability rule.

No Recovery of RCRA Cleanup Costs The past few years have seen a dramatic increase in the number of RCRA private cost recovery actions. Landowners performing UST cleanups or remediating historical contamination have sought relief under § 7002(a)(1)(B) of the RCRA citizen suit provision. This section provides that any person may commence a civil action against "any person . . . who has contributed to the past or present handling, storage, treatment, transportation, or disposal of any solid or hazardous waste which may present an imminent and substantial endangerment to health or the environment." Courts are given broad discretion to fashion any remedy that they deem appropriate.

The RCRA citizen suit provision offers several advantages over CERCLA private cost recovery or contribution actions. First, because CERCLA excludes petroleum from the definition of hazardous substances, property owners cannot bring CERCLA contribution actions to recovery cleanups of petroleum contamination. In contrast, RCRA not only covers petroleum products but also extends to a potentially broader range of substances than CERCLA because RCRA regulates solid wastes. Under RCRA, solid waste includes any "garbage, refuse . . . and other discarded material, including solid, semi-solid or contained gaseous material resulting from industrial, commercial, mining, and agricultural operations, and from community activities. . . ." Courts have held that petroleum fuel leaking from an underground storage tank is a "discarded material resulting from commercial activity" and, therefore, qualifies as a solid waste.

Second, private parties seeking to recover response costs under CERCLA must demonstrate that their costs were "necessary" and that they complied with the National Contingency Plan (NCP). The NCP establishes complex procedures for investigating contamination, selecting remedies, and also requires that the public be given the opportunity to participate in the remedial selection process. RCRA does not contain any NCP requirements. Thus, costs that might be excluded under CERCLA might be recoverable under RCRA.

Finally, unlike CERCLA, plaintiffs may seek recovery of their attorneys' fees under § 7002. It should be noted, though, that several courts have denied awards of attorneys' fees where the plaintiff is a landowner of the contaminated property. In those cases, the courts suggested that where the plaintiff is trying to clean up its own property, it is not acting primarily for the health of the community. Therefore, these courts reason, plaintiff should not be entitled to attorneys' fees.

Most of the private 7002 actions have involved properties that were contaminated by leaking USTs. However, this section has also been used by developers of shopping centers against tenants (e.g., dry cleaning tenants who disposed of hazardous substances at the property), and municipalities that operated sewer systems which leaked hazardous substances into the environment.

The U. S. Supreme Court limited the scope of relief that is available under section 7002 in 1996. In *KFC Western Inc v. Meghrig*, the Court ruled that private parties cannot recover cleanup costs under section 7002 that were incurred prior to the commencement of the litigation. However, the Court left unresolved the question of whether plaintiffs could seek recovery of their cleanup costs incurred after they commenced suit.

It was exactly this issue that was before the court in *Avondale Federal Savings Bank v. Amoco Oil Co.*[8] The plaintiff bank acquired title to a former gasoline station when it merged with another bank. Plaintiff found a purchaser for the property in late 1995. Avondale then performed an environmental audit that was required by the purchase agreement and discovered petroleum contamination from leaking USTs. Avondale then filed a section 7002 action in May 1996 against Amoco Oil Company which had owned and operated the gasoline station from 1926–1970. Avondale sought an injunction requiring Amoco to remediate the contamination. To preserve its sale, Avondale removed the USTs and contaminated soil. In November 1996, Avondale received a no further action letter from the state of Illinois.

After the closing, Avondale amended its complaint to add a claim for restitution to recover the value of the benefit it had conferred upon Amoco by performing the cleanup. Avondale still sought an injunction for any off-site contamination that might exist.

The federal district court granted Amoco's motion for summary judgment on both claims and the U.S. Court of Appeals for the Seventh Circuit affirmed in a 2–1decision. The court interpreted *Meghrig* as prohibiting recovery of any past cleanup costs regardless whether they were incurred before or after suit was filed. The court said that Avondale should have waited for the court to rule on its injunction. The court also noted that Avondale could still seek recovery of its cleanup costs under state law.

It is important to review historical use information of all properties—especially for fast food restaurants, which often buy or lease former service stations sites.

The dissenting opinion vehemently disagreed that *Meghrig* prohibited recovery of cleanup costs after a RCRA citizen suit had been filed. The bank filed a petition with the Supreme Court to reverse the Seventh Circuit's decision. The Court declined to review the decision.

[8] No. 98-2003 (7th Cir. March 11, 1999).

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Avondale illustrates the importance of reviewing the historical information of all properties that may be acquired or leased. Even though a property may currently be used for a purpose that appears to present a low environmental risk, many sites have undergone substantial changes in usage.

This is particularly true with fast food restaurants, where many of the sites were once used as gasoline stations because of their location. Since cleanup practices and standards were not as stringent in the past as they are today, it is important for purchasers acquiring properties by direct purchase or through a corporate transaction to fully investigate the history of the properties being acquired.

CERCLA Contribution Action Against Fiduciary Bank. The Federal Lender Liability Amendments also expressly extended the secured creditor's exemption to financial institutions acting as fiduciaries. Under the amendments, a fiduciary who could be construed as a CERCLA owner can only be liable to the extent of the assets held in a fiduciary capacity and may not be personally liable. However, there is a negligence exception which provides that the limitation on fiduciary liability will not apply if the fiduciary negligently caused or contributed to the release or threatened release of a hazardous substance. Relying on this negligence exception, the U.S. Court of Appeals for the Eleventh Circuit reversed a district court ruling in *In Canadyne-Georgia Corporation v. NationsBank*, and allowed the plaintiff's contribution claim to proceed against the bank.

In this case, a pesticide manufacturer had been owned by a general partnership. More than 50 per cent of the limited partnership interests was held by inter vivos trusts established for the benefit of the general partner's daughters. A predecessor to NationsBank had been appointed as a co-trustee of the daughters' trusts in 1942. After the owner/general partner died in 1945, the bank became trustee of the trust which included the general partnership interest. In 1977, the pesticide business was sold to the plaintiff who, in turn, sold the business in 1984. From 1990 to 1995, the plaintiff was issued orders to remediate contamination at the pesticide plant and to pay for the relocation of residents living near the site.

The plaintiff then filed a suit to recover its response costs under CERCLA, the Georgia superfund law and common law. The plaintiff alleged that the bank served as trustee during the time that hazardous substances had been released at the site. The district court dismissed the plaintiff's complaint on the grounds that the bank was not a liable person under both CERCLA and the state superfund law. However, the Eleventh Circuit said that at the time the bank was serving as trustee, individual partners held title to real property. While the bank technically held the general partnership interest in trust, state law provided that the bank had legal title to and therefore owned the general partnership interest. Therefore, the court said that the bank held title to whatever property the general partnership owned, which in this case was the contaminated plant.

The court then turned its attention to the CERCLA fiduciary exemption that would preclude an action against the bank which held title only by virtue of its status as a trustee. Since the complaint alleged that the bank had negligently caused the release of hazardous substances, the court found that the complaint satisfied the very low threshold that is required for surviving motions to dismiss and allowed the action to go forward. In so holding, the court made it clear that it was not suggesting that the bank was liable under CERCLA. The court added that the bank would be free to bring a motion for summary judgment once limited discovery had been conducted on whether the bank was negligent and whether its negligence had caused or contributed to the release. The appeals court denied the plaintiff's request for reconsideration. The district court will now proceed with a factual inquiry to determine if the releases that took place at the facility could be attributed to the bank's affirmative negligence.

This case shows how easy it may be for a plaintiff to keep a bank in a CERCLA case. While the bank may ultimately prevail in this case, it will be forced to incur litigation costs to demonstrate that it is entitled to the fiduciary exemption. Moreover, because the state superfund law has a different test for determining fiduciary liability, the bank may also have to defend the state superfund claim even if it survives the CERCLA claim. The trust and estate departments of financial institutions should review the standards for fiduciary liability in states where they administer estates that contain operating businesses.

Bank Auctioneer's Liability for Misrepresentation. Many states have statutes which require owners of property to disclose existence of contamination to prospective purchasers. While these laws do not generally apply to the sellers' agents, they can be liable under certain circumstances for fraudulent or negligent misrepresentation.

For example, in *Ramsden v. Farm Credit Services*, the Wisconsin Court of Appeals allowed a claim for misrepresentation to proceed against the auctioneer of contaminated farmland. In that case, the plaintiffs were the high bidder on a dairy farm sold at public auction. The prior owners of the farm had complained to their lender, Agribank, that their cattle were sick and dying. After the prior owners defaulted, Agribank took title and learned that an underground storage tank containing gasoline had been leaking. Tom Hass, an employee of Agribank, notified the state environmental agency who, in turn, ordered Agribank to remove the tank and remediate the contamination. Agribank removed the tank but did not address the soil or groundwater contamination.

Hass conducted the auction for Agribank. During the auction, he told the plaintiffs that Agribank was responsible for remediating any contamination, that the land was suitable for use as a farm and that there was plenty of clean water available for the cattle. He did not mention that the groundwater was contaminated or that cattle had died. Soon after purchasing the farm, the plaintiffs lost 186 cows and one of the plaintiffs became sick. The plaintiffs took water samples to a local university which determined that the water was contaminated with benzene and that the cows had died from benzene poisoning.

In reversing the dismissal of the complaint by a trial court, the appeals court said that while an agent did not have an initial duty to disclose knowledge of the property to the plaintiffs because such a disclosure would have been contrary to the interests of its principal, once the agent did make factual statements he had a duty to make truthful statements. Once the agent has chosen to speak, the court said, the agent may not omit material facts relevant to the condition of the property that the agent has talked about and omissions of which would foreseeably influence the potential purchaser's decision to purchase.

Negligent Misrepresentation Claim Against Bank. Can a bank be liable to a borrower when the real estate appraisal fails to discover environmental contamination? In *Seats vs. Hoover*, a Pennsylvania state court allowed a purchaser of contaminated land to maintain a claim for negligent misrepresentation against the bank when the bank failed to advise the plaintiff that real estate appraisal did not address environmental conditions.

The plaintiff's purchase agreement contained a contingency clause for environmental hazards. The loan application materials provided by the bank contained a statement that when the bank obtained information about environmental conditions from a broker, appraiser, seller or other party to a loan transaction, the information would be provided to the borrower. The statement also indicated that the bank would comply with any state or local reporting requirements.

The bank retained an appraiser but did not provide the appraiser with a copy of the contract with the environmental contingency clause. The appraisal did not observe any adverse conditions. However, the appraiser's report contained a attachment which indicated that the appraiser did not have any information about hidden or unapparent conditions including the presence of hazardous or toxic substances, and that because it was not an environmental expert, the report could not be considered an environmental assessment of the property. The bank approved the loan but did not provide the borrower with a copy of the disclaimer attachment. After the plaintiff began construction of her house and a drinking water well, she learned that the groundwater beneath her property was contaminated from an adjacent landfill. The plaintiff then sued the bank claiming she had relied on the appraiser's conclusion that there were no environmental hazards.

On the claim that the bank negligently inspected the property, the court said the bank owed no duty to inspect the property. However, on the negligent misrepresentation claim, the court said there was a genuine issue of material facts and denied the bank's motion for summary judgment. The court said that to bring a negligent misrepresentation claim, a plaintiff must establish that there was a misrepresentation of a material fact, that the defendant knew or should have known about the misrepresentation, the misrepresentation was made to induce the plaintiff, the plaintiff justifiably relied on the misrepresentation, and the injury resulted from the misrepresentation. The court found a material question whether the bank should have known that the appraiser's report might be erroneous, and that the bank may have given the appraisal to the plaintiff without the attachment as an inducement to close the loan.

Lenders who do not require a borrower to perform environmental due diligence prior to acquiring a property that will be used as collateral for a loan or who rely on environmental insurance policies in lieu of requiring borrowers to perform due diligence should consider providing borrowers with a written disclosure that the waiver of the environmental due diligence requirement or the purchase of an environmental insurance policy does not constitute a finding by the bank that there are no environmental concerns associated with the property. Otherwise, some unsophisticated borrowers who end up facing substantial cleanup costs may argue that they were led to believe by their bank that there were no serious environmental problems associated with the property.

Indeed, two years ago in *Mattingly v. First Bank of Lincoln*, the Montana Supreme Court reversed a summary judgment ruling in favor of a bank and allowed the borrower to proceed with negligent misrepresentation and constructive fraud claims against its former lender because there was a question of material fact whether the bank had created a false impression about the environmental conditions of the property.

Applying CERCLA Secured Creditor Exemption to IDA. Industrial Development Agencies (IDA) can play important roles in brownfield redevelopment. IDAs can issue bonds that can be used to purchase contaminated property and then lease the property to developers or businesses. However, IDAs are often reluctant to take title to property because they are concerned that they could become liable for the cleanup of the sites.

In *Monarch Tile Inc v. Florence*, the trial court ruled that the CERCLA secured creditor exemption applied to an Alabama city that obtained title to contaminated property as part of a statewide industrial development program. The defendant issued an industrial revenue bond to purchase the property and pledged to apply rents and income generated from the property to pay the principal and interest on the bond. The city then leased the property to the plaintiff. After the plaintiff took possession of the site, it learned the site was contaminated with metals and was forced to remediate the site. The plaintiff then sought to recover its cleanup costs from the defendant. In dismissing the plaintiff's motion for summary judgment, the court rejected the argument that because the loan payments went to the bondholders, the city was not acting to protect its security interest. While the city did take title to enhance economic development, the court said, the city retained title to protect its obligations under the bond and therefore fell within the CERCLA secured creditor's exemption.

The U.S. Court of Appeals for the Eleventh Circuit upheld the district court ruling (11th Cir., No. 99-11372, 5/25/00).

On appeal, Monarch tried to distinguish Bergsoe on the grounds that the city had not "held" a security interest but "gave" one to the bond trustee and that the 1996 amendments to the secured creditor exemption had changed the definition of what constitutes a security interest.

However, the Eleventh Circuit noted that Bergsoe had ruled that a party who held bare title and then devoted lease revenue to pay off development bonds did qualify for the secured creditor exemption. The appeals court then ruled that while the 1996 amendments had redefined the term "security interest," there was nothing in the new definition to suggest that Congress did not intend the definition to apply to the type of security interest addressed in this case. In fact, the court suggested that the new broad language referring to "any other right accruing to a person to secure the repayment of money . . . or any other obligation" clearly encompassed the activity at issue in the case.

Monarch also tried to rely on a federal bankruptcy case to claim that the financial documentation should

  TXLR ISSN 0887-7394

be treated as a lease and not a mortgage. However, the Eleventh Circuit held that the bankruptcy case had been governed by state law and that the CERCLA secured creditor exemption clearly included both leases and mortgages within the definition of a "security interest."

The court also rejected Monarch's argument that because state law only authorized the city to purchase property for a public purpose, the city could not hold title for the purpose of protecting a security interest. The court said that governments never acquire property for the purpose of protecting a security interest, but to further some public interest. Once the public purpose has been met, the court continued, a government might retain title or some other indicia of ownership for the duration of the lease to ensure that the bonds are repaid. As a result, the court said, that a government's initial motivation for purchasing land was to further economic development will not preclude it from later qualifying for the secured creditor exemption if it holds indicia of ownership primarily to protect its security interest in the property.

Lenders and Brownfield Sites. During the past few years, approximately 40 states have established voluntary cleanup or brownfield programs (VCPs) to encourage the reuse of abandoned, deteriorating and underused industrial properties, known as brownfields. While many of these brownfield sites have been contaminated with hazardous substances from prior uses, the contamination is usually not serious enough to require a cleanup under CERCLA or to undergo RCRA corrective action.

Nevertheless, the mere perception of contamination has been an obstacle to redevelopment of brownfields despite the fact that these sites have access to a skilled work force, mass transportation, and other infrastructure features. Fear of liability, concerns with reduced collateral values and with the effect that a cleanup will have on the ability of borrowers to repay their loans have also made lenders reluctant to provide financing to redevelop these sites.

The VCPs vary from state-to-state, but they generally include liability protection to prospective purchasers and lenders, establish streamlined cleanup procedures, and authorize the use of risk-based cleanup standards that take future land use into account. VCPs also provide for the issuance of a No Further Action (NFA) letter and Covenant Not To Sue letter after a cleanup has been satisfactorily completed.

Nearly all VCP programs permit risk-based cleanups which establish cleanup standards based on the use of the property. Under this approach, higher levels of residual contamination may be allowed to remain at an industrial site than would be permitted for a residential property. Under such circumstances, institutional controls that impose use restrictions on the property are usually required. Institutional controls can dramatically lower remediation costs. For example, instead of removing contaminated soil, a volunteer may be permitted to encapsulate the contaminated soil with an impermeable cap and then file deed restrictions preventing that portion of the property from being used. In addition, instead of remediating groundwater to drinking water standards, a volunteer may be required to file a deed restriction precluding water under the site from being used for drinking purposes.

Lenders who are contemplating taking 30-year mortgages on remediated sites may be concerned that the state standards may change in the future or that the institutional control may not work effectively (e.g., a construction project inadvertently compromises the integrity of the impervious cap). The state could then require a borrower to perform additional cleanup under the reopener clause in the VCP agreement, which can affect a borrower's ability to repay its loan.

Another problem with institutional controls is that many states have not established sufficient oversight controls for ensuring compliance with the institutional controls. Once a VCP agreement is signed, many states leave enforcement of the restrictions to local government which, in turn, often relies on the good faith of the borrower.

It is extremely important for lenders to carefully scrutinize institutional controls that may have been implemented.

Lenders should be aware that institutional controls often require that the owner be responsible for post-remedial operation and maintenance activities (O & M) such as groundwater monitoring, which can last as long as 30 years. While they can result in an initial reduction in remediation costs, O & M costs often are severely underestimated. As a result, some lenders will not extend financing for sites where remedial actions involve the use of engineering or institutional controls. Instead, they are continuing to insist that the contamination be remediated using the traditional or residential cleanup standards as a condition of the loan.

It is extremely important for lenders to carefully scrutinize institutional controls that may have been implemented for a site to be developed or financed. These restrictions may be a particular concern where there is a soil treatment system installed to remediate contamination caused by volatile organic compounds since the restrictions may prevent excavation of soil which would preclude construction or other development activities. Unless the restrictions can be removed, the property may not be able to be developed in accordance with its highest and best use or even according to the project development plans. Removal of existing restrictions will require approval of the regulatory agency, the owner or PRP responsible for the remediation and the local community. When a non-owner such as a former site operator or owner of an adjacent property is responsible for the remediation, the developer may have a difficult time obtaining the approval of the non-owner PRP since removal of the restrictions will likely result in a more costly cleanup for which the non-owner PRP will want to be reimbursed.

Lenders who finance brownfield redevelopments will usually impose a number of conditions on the financing which restrict their usefulness. First, lenders usually require developers to have at least 25% equity in the project to make sure that the borrower has sufficient capital at risk. Because owners with low equity interests abandoned property during the last decline in the real estate market, many lenders will require owners to maintain sufficient equity to ensure an owner's commitment to the project. However, in today's hot real estate market, many owners have been able to obtain loans that exceed their original acquisition costs.

Second, the rule of thumb used by many banks is that the remediation costs cannot exceed 25 per cent of the fair market value of the unimpaired property.

Third, the loan proceeds often cannot be used to finance the cleanup. Instead, the borrower is expected to use its own equity or find other sources to fund the site investigation and cleanup. Because of these requirements, usually only the smaller properties with rather limited contamination have been financed through traditional bank lending. In addition, the nature of the contamination can influence the availability of financing. For example, a site with soil that is contaminated with petroleum may be easier to finance than a site with groundwater contaminated with chlorinated solvents.

The expedited cleanup procedures and NFA Letters that are available under the VCPs can help lenders quantify the risks posed by a site. Many financial institutions require pre-approval of a remediation action plan (RAP) and remediation schedule by the state environmental authority as a condition of the loan commitment. In some cases, banks may also require the developer to enter into a VCP agreement where the state will issue an NFA and covenant not to sue in favor of the borrower and the lender. If there is concern that EPA may be interested in the site, some lenders may also request that the borrower enter into a prospective purchaser agreement with the EPA, which can insulate the developer, lender, and seller from future liability.

Many VCPs also offer grants and loans that may be used to defray cleanup costs. Borrowers can use these financial programs as well as the insurance products mentioned earlier to lower the risk ratio of the loan.

State Common Law Liability Persists. In 1989, the U.S. Court of Appeals for the First Circuit ruled in *Waterville Industries Inc. v. Finance Authority of Maine* that the CERCLA secured creditor exemption provided immunity to a state finance authority. Not deterred by this adverse holding, the property owner subsequently filed a breach of contract action in state court claiming that the finance authority failed to disclose the presence of contamination at the site.

The finance authority had foreclosed on the property in 1980 after a wool-processing mill had defaulted on its loan. Before selling the site at auction, the finance authority received three letters from the state attorney general indicating it had been informed by the state DEP the site had two unused waste lagoons that had to be closed. The attorney general told the finance authority that while closure was overdue, the DEP would not require closure at that time. However, the DEP requested that the finance authority close the lagoons or require closure as a condition of the sale.

When Waterville Industries purchased the property in 1983, the finance authority did not disclose the existence of the lagoon. In the late 1980s, the EPA issued an administrative order against Waterville for failing to close the lagoons and entered into a consent order with the company in 1989 to remediate the site and pay civil penalties.

In 1993, a jury awarded Waterville $150,000 in damages on its breach of contract claim. The state appealed, claiming that the CERCLA ruling precluded the contract claims.

This summer, the Maine Supreme Court ruled that the state action was not barred by the CERCLA ruling since the federal court had no jurisdiction over the state claim. Moreover, the action was not barred by the doctrine of election because the state never had a claim against the state under CERCLA. However, the supreme court remanded the case to the trial court to determine if material evidence had been improperly excluded at trial.

The CERCLA secured creditor exemption does not insulate financial institutions from state common law claims.

This case once again illustrates that the CERCLA secured creditor exemption does not insulate financial institutions from state common law claims. While many states have enacted state lender liability statutes, these laws generally provide liability relief from statutory contribution or cost recovery actions and not common law claims. A number of states also have environmental disclosure statutes which require disclosure of environmental conditions. Lender liability statutes in those states generally do not provide protection for failure to comply with the disclosure requirements. Lenders should carefully review the provisions of state lender liability laws and the scope of environmental disclosure laws as part of their loan due diligence.

In Re Duplan. In exchange for providing financing to a company, hedge funds and institutional investors often receive stock or high interest subordinated notes or other debt instruments. Because these financial instrument usually do not convey a controlling interest in a company, the investors are generally not concerned about the possibility that they could become liable under CERCLA. As a result, they often do not perform environmental due diligence.

While it is true that CERCLA liability has not been imposed on a party solely based on stock ownership, the CERCLA liability net is still quite wide. A recent decision by the U.S. Court of Appeals for the Second Circuit illustrates how an investment bank which simply held stock in a reorganized company can be drawn into a CERCLA contribution action.

In *In Re Duplan Corp et al v. Esso Virgin Islands. Inc.*, Duplan Corp. filed a petition for reorganization under the old Bankruptcy Act in 1976. Six years before the bankruptcy filing, Duplan had acquired Laga Industries, Ltd., a textile manufacturer located in the Virgin Islands. In 1979, the District Court for the Southern District of New York allowed the reorganization trustee to sell the Laga facility located in Tutu, St. Thomas. In 1981, the reorganization plan was confirmed.

Pursuant to the confirmation order, Laga was dissolved and Duplan was renamed Panex Industries Inc. The creditors of Duplan were given cash and shares in Panex in partial satisfaction of their claims. One of the creditors who received share in Duplan/Panex was Goldman, Sachs & Co.

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The confirmation order also permanently enjoined all creditors from asserting, continuing or commencing any claims against Duplan which arose prior to the filing of the bankruptcy petition. However, the permanent injunction did not apply to administrative claims arising after the filing of the petition and before the confirmation plan was approved. Duplan/Panex expressly assumed such claims.

In 1983, the district court issued a Final Decree discharging the debts of Duplan/Panex and barring persons with claims against Duplan/Panex from commencing or pursuing lawsuits against the company or any party with an interest in Duplan/Panex. In September 1984, Panex sold off its major operating subsidiaries and the shareholders voted to dissolve the company. A certificate of dissolution was filed in April 1985. Over $64 million in proceeds were then distributed to Duplan/Panex shareholders including over $9 million to Goldman Sachs. In September 1985, a liquidating trust in the amount of $6 million was created to cover any contingent liabilities of the company.

The proxy statement for the liquidating trust which was provided to all shareholders expressly indicated that if the funds in the trust were insufficient to cover the company's liabilities, each shareholder could be liable for any unpaid liabilities up to the amount of the distribution they received from the liquidation of the company. After no significant claims surfaced, the trust distributed another $4.5 million to the former shareholders in July 1987, leaving approximately $1.1 million remaining in the trust.

In 1987, EPA discovered that property adjacent to the former Laga facility was contaminated with a variety of hazardous substances. In 1988, EPA performed a removal action and notified a number of oil companies that they had been identified as PRPs for the site. In 1989, property owners and lessees whose wells were contaminated filed a lawsuit against the PRPs seeking damages. In 1992, the PRPs brought a $20 million CERCLA contribution claim as well as RCRA and common law claims against Duplan/Panex and its former officers and directors (the Laga defendants) claiming that Laga was responsible for the PCE that had been detected in the groundwater. A series of complicated rulings followed.

The Laga defendants filed a motion in the federal district court for the Virgin Islands arguing that they could not be sued under the Delaware dissolution statute and that the bankruptcy proceeding had discharged the claims. The court ruled that the common law claims were barred by the state dissolution statute, but refused to dismiss the CERCLA claims because CERCLA preempted the state dissolution statute. The court further held that because CERCLA was enacted in 1980, the CERCLA claims were not discharged.

After the PRPs obtained an injunction from the court preventing the trustee from winding up the trust, the U.S. Court of Appeals for the Third Circuit reversed the injunction and instructed the district court to dismiss the CERCLA claims because they were time-barrred by the state dissolution statute.

Unable to proceed against the Laga defendants, the PRPs then filed a CERCLA contribution action against the Trust and the shareholder-distributees. The district court held that under Delaware law, the liquidating trust was in essence a continuation of the dissolved corporation for the purpose of resolving claims by and against the dissolved corporation. The court also refused to grant the defendant's motion that the PRPs could not proceed against the shareholders who had received liquidating distributions from the corporation and distributions from the assets of the liquidating trust. The court also issued an injunction preventing the trustee from disbursing any additional assets of the trust to pay off remaining debts of the corporation or from filing a motion in the Delaware Chancery Court to terminate the trust since this could effectively terminate the CERCLA and other environmental claims.

In 1996, Goldman filed a motion with the bankruptcy court to enforce the injunction prohibiting lawsuits against those having interests in Duplan/Panex. However, the bankruptcy court ruled that the discharge only applied to claims that arose prior to the filing of the petition. Since CERCLA was enacted after the petition had been filed and after the bar date for filing proofs of claim, the court held that the CERCLA claims were not discharged.

The bankruptcy court ruling was affirmed by the district court in 1999 and by the U.S. Court of Appeals for the Second Circuit this fall. The Second Circuit indicated for a bankruptcy claim to be valid, the claimant must have a right of payment and that right must arise before the petition is filed. The court said that a claim would be deemed to have arisen pre-petition if some legal relationship had been in existence between the debtor and creditor before the petition was filed. The court further noted that all of the elements comprising that legal obligation had to be satisfied prior to the filing of the bankruptcy petition.

The court then found that CERCLA created a new scheme of liability. Even though the conduct leading to the CERCLA liability may have taken place before the bankruptcy petition, the court ruled that the CERCLA statutory claims could not have arisen until the statute had been passed in 1980. Assuming that those claims arose on the date CERCLA was enacted, the court said the CERCLA claims could be considered administrative claims which the reorganized corporation had expressly assumed and agreed to pay. However, the court specifically indicated it was not determining that the claims arose at that time and before the issuance of the confirming order. The court did bar the RCRA section 7002 actions because EPA had satisfied the diligent prosecution requirement.

On the common law claims, the appeals court found that the bankruptcy court had not determined when those claims arose. As a result, the court remanded the CERCLA and common law to the district court for further consideration.

It is important to remember that the CERCLA secured creditor exemption only protects lenders when they have indicia of ownership primarily to protect a security interest. A secured creditor can still generate profits such as interest and fees without forfeiting its immunity from liability so long as the lenders primary purpose was to protect its security interest. The exemption did not apply in this case because the bank had an investment interest in the company.