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Appeals Court Expands Environmental Liability for Lenders

By Larry Schnapf • Lord Day & Lord, Barrett Smith • New York

In a decision that could have extremely far-reaching implications for all lenders, a federal court has ruled for the first time that a lender is liable for environmental pollution caused by a borrower simply because the lender had the *ability to control* the borrower's hazardous waste practices—*even if the lender did not exercise actual control* (*United States v. Fleet Factors Corp.*, U.S. Ct. App. 11th Cir. (May 23, 1990)). This decision is, of course, applicable only to the particular facts of the case decided. If its logic is adopted by other courts, however, it will dramatically broaden the environmental liability of lenders.

Factual Background of the Case

Fleet Factors (Fleet) entered into a factoring agreement with Swainsboro Print Works (SPW) in 1976 in which Fleet extended advances to SPW in exchange for an assignment of its accounts receivable. The loan was secured by all of SPW's machinery, equipment, fixtures, and inventory including raw materials and work-in-progress. As additional security, Fleet also took a mortgage on the textile production site.

Three years later, SPW filed for Chapter 11 and Fleet continued to advance funds to SPW. In early 1981, SPW ceased operations and began to wind down its affairs. During this period, Fleet continued to collect on the accounts receivable assigned to it under a debtor-in-possession (DIP) financing arrangement. More importantly, in the eyes of the court, Fleet required SPW to obtain approval before shipping goods to customers, established the price for excess inventory, dictated when and to whom finished goods could be shipped, determined when employees should be terminated, supervised the activity of the office administrator, received and processed SPW's employment and tax forms, and controlled access to the facility. There was also evidence that Fleet asserted control over SPW's hazardous waste disposal practices by prohibiting SPW from selling several barrels of chemicals to potential buyers.

In December 1981 SPW filed for Chapter 7 liquidation; Fleet was authorized by the bankruptcy court to foreclose on the inventory and equipment in May 1982. However, Fleet did not foreclose on the real property. (It was eventually abandoned to the county for unpaid state and county taxes in July 1987.) Fleet contracted with a liquidator to conduct an auction of SPW's fixtures and equipment in June 1982. After the auction, Fleet hired a rigger to remove the unsold equipment; this was completed in December 1983.

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EPA Action

Shortly thereafter, the Environmental Protection Administration (EPA) discovered that there were on the SPW site about 700 rusting or leaking drums and several holding tanks and vats containing hazardous substances and four truckloads of materials containing asbestos. These were removed at a cost of about $400,000. The EPA filed an action against Fleet to recover this cost on the grounds that Fleet was liable because it had overstepped the bounds of a normal lender and become the operator of the facility.

Under federal law (Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA)), current or past owners and operators of a facility may be liable for cleanup costs associated with discharges of hazardous substances. CERCLA contains an exemption for a lender who "without participating in the management of . . . a facility, holds indicia of ownership primarily to protect . . ." a security interest. However, a secured creditor may lose its immunity for cleanup obligations if the lender becomes too entangled in the day-to-day management of the borrower's operations.

In a partial victory for lenders, the federal district court found that Fleet's actions prior to foreclosure did not amount to sufficient involvement and control over the borrower to warrant imposing liability on it as an operator of the facility. The district court said that a lender could provide general financial assistance and isolated instances of specific management advice to its debtors without risking federal environmental liability if the secured creditor did not participate in the day-to-day management of the business or facility either before or after the business ceases operations.

However, the court found that there were genuine issues of fact whether Fleet's agents were responsible for the hazardous substances on SPW's premises after the foreclosure, which could render Fleet liable as an operator of the facility.

The Appellate Decision

On appeal, a three judge panel agreed with the district court that Fleet's pre-foreclosure activities were insufficient to remove the cloak of lender immunity. However, the panel ruled that the actions EPA charged that Fleet took after foreclosure and before the auction would, if proved at trial, be sufficient to impose liability on Fleet.

The most important holding of the case was the court's pronouncement that a lender could be liable for cleanup costs if the lender simply had the power or ability to influence the borrower's hazardous waste practices *even though its involvement with those operations fell short of qualifying the lender as a CERCLA-defined operator*:

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should consider foreclosing on the *second* lien, thereby preserving the guarantor's liability on the first lien debt (other considerations may suggest an opposite conclusion, however, and must be weighed).

Cross-Collateralization

A lender should take these same considerations into account in cases where loans are cross-collateralized and cross-defaulted. If the same lien on collateral secures both a guaranteed note and a second note that is not guaranteed, the foreclosure documentation should provide that the foreclosure is being conducted to satisfy the unguaranteed note, and the foreclosure proceeds should be applied to that note.

Lender Liability

(Cont'd from page 2)

> It is not necessary for the secured creditor actually to involve itself in the day-to-day operations of the facility in order to be liable.... Nor is it necessary for the secured creditor to participate in management decisions relating to hazardous waste. Rather, a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it *could* affect hazardous waste disposal decisions if it so chose. (Emphasis added.)

In this holding, the court lowered the threshold for lender liability for borrowers' hazardous substances and even seemed to carve out a new CERCLA liability category specifically directed at lenders who are less than statutory "owners" or "operators."

The decision also contained sobering language that elevated lenders to the role of surrogate regulators responsible for ensuring that industry complies with hazardous waste laws:

> Our ruling today should encourage potential creditors to investigate thoroughly the waste treatment systems and policies of potential debtors. If the treatment system seems inadequate, the risk of CERCLA liability will be weighed into the terms of the loan agreement. Creditors, therefore, will incur no greater risk than they bargain for and debtors, aware that inadequate hazardous waste treatment will have a significant adverse impact on their loan terms, will have powerful incentives to improve their handling of hazardous wastes.
>
> Similarly, creditors' awareness that they are potentially liable under CERCLA will encourage them to monitor the hazardous waste treatment systems and policies of their debtors and insist upon compliance with acceptable treatment standards as a prerequisite to continued and future financial support. Once a secured creditor's involvement with a facility becomes sufficiently broad that it can anticipate losing its exemption from CERCLA liability, it will have a strong incentive to address hazardous waste problems at the facility rather than studiously avoiding the investigation and amelioration of the hazard.

Finally, the decision could sound the death knell for an earlier line of cases that have viewed the secured creditor's exemption under CERCLA as covering instances in which the lender's actions were taken solely to protect its security interest. The court said that the nature and extent of the creditor's involvement with the facility and not its motive was the sole relevant issue.

Conclusion

This decision does little to assist lenders in defining a bright line between prudent oversight of a borrower's business and excessive entanglement in its operations sufficient to bring environmental liability on the lender. On the contrary, it seems to further blur distinctions relied on previously. Nevertheless, it still requires lenders to take some affirmative steps towards operational or financial control before they forfeit their immunity from CERCLA liability. The mere existence of unexercised loan provisions authorizing lenders to take certain management-type actions without more intrusive actions on the part of the lender should not expose lenders to liability. If lenders merely instruct their borrowers to comply with hazardous waste laws while leaving the choice of methods to remedy waste problems entirely and completely to the discretion of the borrower, they should not incur liability.

Because lenders can perform environmental due diligence prior to booking loans, this decision should not be a significant burden to originating new loans. However, it poses danger to banks during workouts. During a workout, the panoply of individual discrete actions taken by loan officers in an effort to maximize repayment by the borrower could appear to a court in retrospect as amounting to sufficient involvement in the borrower's activity to warrant imposition of cleanup liability on the bank.

This opinion once again affirms the importance of performing environmental due diligence investigations both prior to booking loans and before engaging in workouts or foreclosures. Indeed, the court indicated that it *expects* lenders to monitor the hazardous waste practices of their borrowers and to insist upon compliance with hazardous waste laws. Environmental due diligence investigations will not only minimize lenders' involvement with potentially troublesome loans but could also enable the creditor to use the "innocent purchaser's defense" under CERCLA. This defense can enable an owner or operator to shield itself from liability if it can demonstrate that it conducted a commercially appropriate investigation into the prior uses of the property before acquiring title.

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