THE REVIEW OF
BANKING & FINANCIAL SERVICES
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING BANKING AND RELATED INDUSTRIES
PUBLISHED BY STANDARD & POOR'S, A DIVISION OF THE MCGRAW-HILL COMPANIES INC.

Vol. 12, No. 18 October 23, 1996

CONGRESS AMENDS CERCLA TO EXPAND LENDER LIABILITY PROTECTION

Recent Legislation Codifies the EPA's Lender Liability Rules, Permitting Lenders To Protect Their Interests in Real Property if They Do Not Participate in Management of Operational Affairs. The New Act also Clarifies the Liability of Fiduciaries, and Extends the Secured Creditor Exemption to Third-Party Actions.

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Ever since a federal circuit court of appeals invalidated the Environmental Protection Agency's ("EPA") lender liability rule in 1994, financial institutions have been uncertain about their liability under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"). Recently, Congress provided some relief to financial institutions when it enacted the "Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 (the "Lender Liability Amendments") on September 30th as part of the Omnibus Consolidated Appropriations Act for fiscal year 1997. [1]

1. H.R. 3610, P.L. 104-208 (September 30, 1996).

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The Lender Liability Amendments add new provisions to CERCLA and the federal Resource Conservation and Recovery Act ("RCRA"), which clarify the scope of the secured creditors exemption contained in both statutes. While the legislation provides lenders with greater certainty concerning the scope of their liability under CERCLA and RCRA, it falls short of completely immunizing lenders from liability under CERCLA and other federal or state environmental laws. Moreover, lenders still need to exercise extreme caution when foreclosing on real property secured with a mortgage or selling personal property that serves as collateral for a borrower who has defaulted on a loan.

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OVERVIEW OF LENDER LIABILITY

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" contains an 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.

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 clean up contamination caused by hazardous or solid wastes. RCRA contains a secured creditor's exemption that is 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, and marketing.[2] The EPA issued its RCRA lender liability rule interpreting the scope of the RCRA secured creditor's exemption in 1995.[3]

While no courts have interpreted the RCRA exemption, there were several CERCLA cases in the late 1980s which suggested that lenders could be subject to CERCLA liability if they foreclosed on contaminated property or became too involved in the day-to-day management of the borrower's operation. The lenders in these cases were not actually found to be liable. Instead, the courts simply denied summary judgment motions filed by the lenders. Moreover, these decisions were often contradictory. For example, two early cases construed the exemption broadly and held that an acquisition of title through foreclosure was an incident to protecting a security interest and should not, by itself, expose a lender to liability.[4] However, other courts adopted a more narrow view of the exemption and held that a lender could be liable if it forecloses on property regardless of its motives or how long it held title.[5]

When the Court of Appeals for the Eleventh Circuit suggested in 1990 in *U.S. v. Fleet Factors*[6] that banks could forfeit their immunity from CERCLA liability if they had the mere *ability* to control their borrower's operation, pressure grew to amend the secured creditor's exemption legislatively. Fearing that such amendments could lead to widespread evisceration of CERCLA, the EPA promulgated its lender liability rule in 1992 (the "CERCLA Lender Liability Rule).[7] This rule expressly rejected the holding in *Fleet Factors*. EPA also said that lenders would not be exposed to liability if they simply exercised financial oversight over a borrower's operations, but could become liable if they exercised control over the operational aspects of the business. The agency also stated that financial institutions could engage in common workout practices without losing their exemption from liability and set forth a non-exclusive list of permissible workout activities. Finally, EPA indicated that lenders could foreclose on contaminated property

2. 42 U.S.C. 6991(b)(h)(9).
3. September 7, 1995, 60 FR 46698.

4. *U.S. v. Mirabile*, 15 Envtl. Law. Rep. (Envtl. Law. Institute) 20994 (E.D. Pa. Sept. 4, 1985); *In re Bergsoe Metals*, 910 F.2d 688 (9th Cir. 1990)
5. *U.S. v. Maryland Bank & Trust Co.*, 632 F.Supp. 573 (D. Md. 1986); *Guidice v. BFG Electroplating & Manufacturing Co.*, 732 F.Supp. (WD Pa. 1989).
6. 901 F.2d 1550 (11th Cir. 1990).
7. 57 Fed. Reg. 18344 (April 29, 1992), codified at 40 C.F.R. 300.1100.

Standard & Poor's
A Division of The McGraw-Hill Companies

Published 22 times a year by Standard & Poor's, a division of The McGraw-Hill Companies. Executive Office 25 Broadway, New York, New York 10004. Editorial Office, 1133 Avenue of the Americas, New York, New York 10036-6710. Annual subscription: $630/yr.

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and remain insulated from liability if the lender tried to resell the property in an expeditions manner. The agency created a bright-line test for lenders to follow that would automatically establish that the lender was foreclosing to protect its security interest and would thus permit it to remain within the protection of the exemption.

However, in 1994 the federal Court of Appeals for the District of Columbia ruled that the EPA had exceeded its authority when it issued the CERCLA Lender Liability Rule and vacated the rule.[8] Lenders were then faced with the prospect of having their liability resolved on a jurisdiction-by-jurisdiction basis. EPA reissued the CERCLA Lender Liability Rule as a guidance document in 1995. However, this action did not provide much comfort to the financial community since a guidance document can not preclude actions filed against financial institutions by private parties. Moreover, approximately a dozen states enacted their own lender liability statutes which established the circumstances under which secured lenders would be immune from liability under the various state versions of CERCLA. The protection afforded by these state statutes varied since many of the state lender liability statutes did not mirror the provisions of the EPA lender liability rule.

THE 1996 LENDER LIABILITY AMENDMENTS

The Lender Liability Amendments essentially codify the provisions of the CERCLA Lender Liability Rules. In so doing, the amendments provide EPA with the statutory basis for the CERCLA Lender Liability Rule that the court of appeals indicated was lacking when EPA promulgated the regulation in 1992. In addition, the Lender Liability Amendments reinstate the portion of the CERCLA Lender Liability Rule governing involuntary acquisitions by government entities from the date of its promulgation, and further states that the no court shall have the right to review that portion of the Lender Liability Rule that was enacted in 1992.[9]

The amendments add a new section entitled "Exclusion of Lenders Not Participants in Management" to the end of the definition of owner or operator appearing in section 101(20).[10] This new section restates the original secured creditor's exemption and then adds a number of definitions.

8. *Kelley v. EPA*, 15 F.3d 1100 (D.C. Cir. 1994).
9. Lender Liability Amendments, section 2504.
10. Id., section 2502(b)

Key Definitions

Instead of referring to the term "holder" which appears in the CERCLA Lender Liability Rule, the amendments contain a detailed definition of a "lender," which includes the following:

• an insured depository institution as defined by section 3 of the Federal Deposit Insurance Act;

• an insured credit union as defined by section 101 of the Federal Credit Union Act;

• a bank or association chartered under the Farm Credit Act of 1971;

• a leasing or trust company that is an affiliate of an insured depository institution;

• any person (including a successor or assignee) who makes a bona fide extension of credit to or takes or acquires a security interest from a non-affiliated person;

• the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the federal Agricultural Mortgage Corporation, and any other entity that buys or sells loans or interests in loans in a bona fide matter;

• a person who insures or guarantees against a default in the repayment of an extension of credit, or acts as a surety with respect to an extension of credit to a non-affiliated person; and

• a person who provides title insurance and who acquires a vessel or facility as a result of an assignment or conveyance in the course of underwriting claims or settling claims.[11]

Another new term is the definition of "security interest." This term includes "a right under a mortgage, deed or trust, assignment, judgment lien, pledge, security agreement, factoring agreement, or lease and any other right accruing to a person to secure the repayment of money, the performance of a duty, or any other obligation by a non-affiliated person."[12]

The amendments also contain definitions to distinguish between operational control of a borrower and financial or administrative oversight. The term "operational func-

11. Id., section 107(20)(G)(iv)
12. Id., section 107(20)(G)(vi)

tion" refers to a function "such as that of a facility or plant manager, operations manager, chief operating officer, or chief executive officer"[13] while "financial or administrative function" includes those functions like that of "a credit manager, accounts payable officer, accounts receivable officer, personnel manager, controller, or chief financial officer, or a similar function".[14] These two definitions track the examples set forth in the CERCLA Lender Liability Rule.

A new term that did not appear in the CERCLA Lender Liability Rule is the definition of "extension of credit." This term encompasses lease/back transactions where "the lessor does not initially select the leased vessel or facility and does not during the lease term control the daily operations or maintenance of the vessel or facility" or where the transaction "conforms with regulations issued by the appropriate federal banking agency or appropriate state bank supervisor."[15]

The Lender Liability Amendments also added a definition of "foreclosure." This term refers to the acquisition of a facility or vessel through the following means:

- purchase at sale under a judgment or decree, power of sale, or non-judicial foreclosure sale;

- a deed in lieu of foreclosure, or similar conveyance from a trustee;

- repossession;

- conveyance pursuant to a previous extension of credit, including the termination of the lease agreement; or

- any other formal or informal means in which a person acquires title to or possession of a vessel or facility for subsequent disposition in order to protect its security interest. [16]

Participation in Management

The Lender Liability Amendments expressly state that "participation in management" requires actual participation in the management or operational affairs of a vessel or facility and does not include merely having the capacity to influence, or the unexercised right to control facility or vessel operations. Thus, Congress rejected the language contained in the *Fleet Factors* decision and confirmed that the mere presence of clauses in a financing agreement giving a lender the right to take certain actions such as responding to violations of law or releases of hazardous substances will not expose the lender to liability. [17]

Congress also adopted the two-prong test of the vacated CERCLA Lender Liability Rule . A lender will be considered "participating in management" if, while the borrower is still in possession of the facility or vessel that is encumbered by the security interest, the lender:

- exercises decision-making control over environmental compliance for the facility or vessel so that it has undertaken responsibility for hazardous substance handling or disposal practices; or

- exercises control or responsibility for the overall management of the vessel or facility (including day-to-day decision-making for environmental compliance), or over substantially all of the operational functions of the facility or vessel other than environmental compliance.[18]

To provide further guidance to lenders, the Lender Liability Amendments contain a list of nine categories of actions that would not constitute "participation in management." It is unclear what value these examples provide, however, because the statute indicates that these actions will not rise to "participation in management" so long as they do not fail the two-prong test. The nine categories are:

- holding, abandoning, or releasing a security interest;

- including environmental terms, conditions, covenants, or warranties in an extension of credit, security agreement, or other loan agreement;

- monitoring or enforcing the terms and conditions of the extension of credit or security interest;

- monitoring or undertaking one or more inspections of the vessel or facility;

- requiring the borrower to undertake a response action or other lawful means to address a release of hazardous substances prior to, during, or upon the expiration of the extension of credit;

- providing financial or other advice or counseling to mitigate, prevent, or cure default or diminution of the value of the vessel or facility;

13. Id., section 107(20)(G)(v)
14. Id., section 107(20)(G)(ii)
15. Id., section 107(20)(G)(i)
16. Id., section 107(20)(G)(iii)
17. Id., section 107(20)(F)(i)
18. Id., section 107(20)(F)(ii)

•restructuring, renegotiating, or otherwise agreeing to alter the terms and conditions of the extension of credit or the security interest and exercising forbearance;

•exercising other remedies that may be available under applicable law for the breach of a term or condition of the extension of a creditor's security interest; or

•conducting a response action under section 107(d) of CERCLA or under the direction of an on-scene coordinator ("OSC") appointed under the National Contingency Plan ("NCP").[19]

Foreclosure

Like the CERCLA Lender Liability Rule, the Lender Liability Amendments allow financial institutions to foreclose, re-lease (in the case of a sale/leaseback transaction), or sell its collateral so long as the lender attempts to divest itself of the facility or vessel "at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."[20]

This provision does not contain the "bright-line test" that was contained in the CERCLA Lender Liability Rule. The test required lenders to list the property within a certain period of time and to accept offers for "fair consideration." Lenders that met the test were automatically deemed to have acquired indicia of ownership primarily for the purpose of protecting their security interest and therefore would fall within the protection of the exemption.

In the absence of such a bright-line test, lenders will not be able to know for certain if their actions are consistent with the exemption and may find themselves subject to scrutiny by individual courts to determine if they acted "at the earliest practicable, commercially reasonable time, on commercially reasonable terms." Many lenders have established real estate divestiture policies to govern the foreclosure and sale of collateral. It is possible that a lender might be able to point to compliance with its internal policies as evidence that it acted "at the earliest practicable, commercially reasonable time, on commercially reasonable terms." Because of the uncertainty over what constitutes "the earliest practicable, commercially reasonable time, on commercially reasonable terms," the real estate divestiture groups of financial institutions should work closely with environmental counsel to make sure that the lending institution does not inadvertently lose its immunity.

19. Id., section 107(20)(F)(iii)
20. Id., section 107(20)(E)(ii)

Post-Foreclosure

The Lender Liability Amendments provide that a lender may maintain business operations; wind down operations, take measures to preserve, protect, and prepare the vessel or facility for sale or disposition; and even undertake response actions under section 107(d)(1) of CERCLA or under the direction of an OSC, so long as the lender complies with the foreclosure requirements set forth above.

Lenders have encountered their greatest risk of liability when involved in post-foreclosure activities. Aside from the *Fleet Factors* case, there are a number of unreported decisions involving lenders that have been issued administrative orders by governmental agencies and have had to pay to perform a cleanup because of the actions they took following foreclosure. These situations have typically occurred where a borrower has gone out of business and a bank has taken control of the facility in order to sell off the inventory, fixtures, machinery, and equipment of the borrower that is subject to the bank's lien. The bank typically does not take title to the property because of fear that it will lose its exemption but, instead, conducts an auction to sell the personal property. Usually there are barrels or drums of hazardous waste strewn about the facility and the equipment that is being auctioned off may even contain hazardous wastes. In order to avoid any suggestion that the bank or the auctioneer had any control over the hazardous wastes, the auctioneer will often rope off the area where the drums or barrels are found. In some cases, the bidders are actually allowed to cherry-pick barrels containing useful raw materials. After the auction is conducted, the drums and barrels are often left in the abandoned facility. At some point, government authorities find out that there are abandoned drums at the facility and order the lender to pay for the removal of the materials.

Lenders will often argue that the drums containing the wastes were not part of its collateral or that the lender never exercised control over the drums because neither it nor its auctioneer ever touched or moved them. However, the definition of "release" under CERCLA includes abandonment of drums. Thus, a lender who has taken control of a facility to conduct an auction and leaves behind drums or equipment containing hazardous wastes could be deemed to have caused a threatened release of hazardous substances.

Moreover, the CERCLA Lender Liability Rule provided that while lenders were not required to take response actions in order to retain their immunity from liability, they had to comply with the law, and any actions that they did take had to comply with the NCP. Abandonment

of drums or equipment would not be consistent with the requirements of the NCP and could cause a lender to lose its immunity, even where it has complied with all of the aspects of the CERCLA Lender Liability Rule.

The Lender Liability Amendments did not expressly address this issue of post-foreclosure NCP compliance. Thus, financial institutions should exercise extreme caution when conducting auctions and should consult with environmental counsel prior to conducting any auction at a manufacturing facility. It would also be advisable for lenders to retain an environmental consultant or environmental attorney to inspect the facility prior to arranging for the auction and probably even before taking control of the facility in order to evaluate the possible environmental liabilities that might be associated with the auction.

If the lender decides to have the hazardous wastes removed, it should try to have a representative of the borrower execute the waste manifests so that the bank would not be considered the generator of the waste. However, if no such representative is available, the bank or one of its agents would have to execute the waste manifests. Since the bank would be considered a generator of the waste under these circumstances, the lender should select a reputable disposal or treatment facility. The financial institution could have its environmental consultant or attorney perform a regulatory review of the facility to minimize the possibility that the lender could incur liability for releases of hazardous substances at that treatment or disposal facility.

LIABILITY OF FIDUCIARIES

One of the major drawbacks of the CERCLA Lender Liability Rule was that it did not apply to financial institutions acting in a fiduciary capacity. The Lender Liability Amendments fill this void by adding a new subsection to section 107 of CERCLA which clarifies the scope and standard of liability for fiduciaries.[21] The new subsection 107(n) applies to anyone holding title, having control, or otherwise having an interest in a facility or vessel pursuant to the exercise of its responsibilities as a fiduciary. Persons covered by this new subsection include the following:

- trustees;
- receivers;
- executors;
- administrators;
- custodians;
- guardians of estates or a guardian ad litem;
- conservators;
- committee of estates of incapacitated persons;
- personal representatives;
- a trustee under an indenture agreement, trust agreement, lease, or similar financing agreement for debt securities, certificates of participation in debt securities, or other forms of indebtedness where the trustee is not the lender, or
- a representative that EPA determines is acting in one of the foregoing capacities.

However, a fiduciary does not include a person acting as a fiduciary for an estate organized for the primary purpose of, or which is engaged in or actively carrying on a trade or business for profit, or a person that acquires ownership or control of a vessel or facility with the objective of avoiding liability

The new fiduciary section 107(n) does not apply to persons who are both fiduciaries and beneficiaries of the same fiduciary estate and who receive benefits that exceed the customary or reasonable compensation and incidental benefits. In addition, it does not apply to the assets of the estate or trust or to a non-employee agent or independent contractor of the fiduciary.

The new subsection provides that a fiduciary shall only be liable for releases or threatened releases of hazardous substances from a facility or vessel held in a fiduciary capacity up to the value of the assets held in the trust or estate, so long as the release or threatened release was not caused by the negligence of the fiduciary. In addition, a fiduciary will not be exposed to personal liability by undertaking or directing another person to take response actions to address releases or threatened releases of hazardous substances. A fiduciary will also not forfeit its immunity from liability by taking the following actions:

- terminating the fiduciary relationship;
- including covenants or other conditions requiring compliance with environmental laws in the fiduciary agreement;

21. Id.

• monitoring or conducting inspections of a facility or vessel;

• providing financial advice or other advice to other parties in the fiduciary relationship including the settlor or beneficiary;

• restructuring or renegotiating the terms of the fiduciary relationship;

• administering a vessel or facility that was contaminated prior to the commencement of the fiduciary relationship;

• declining to take any of the foregoing actions.

It is unclear if the latter requirement means that a fiduciary who fails to respond to a release of hazardous substances can still take advantage of the fiduciary safe harbor. As discussed above in the post-foreclosure section, the CERCLA Lender Liability Rule required lenders to take actions consistent with the NCP such as removing abandoned drums at a facility they have foreclosed upon in order to preserve their immunity. A fiduciary who has knowledge of a release would probably be well-advised to authorize response actions to address any such release or threatened release since such actions will not expose the fiduciary to liability, and the failure to take such action might amount to negligence that could expose the fiduciary to personal liability.

Third-Party Actions

The CERCLA Lender Liability Rule did not extend protection for secured creditors against actions filed by third parties. Since most lender liability cases are brought by private parties, this was a major concern to the financial lending community. By amending the definitions of owner or operator and the liability provisions of CERCLA, the legislation seems to have addressed this flaw. Private parties will now have the burden of establishing that a lender is a PRP and does not qualify for the secured creditor's exemption.

RCRA Conforming Amendments

The Lender Liability Rule amends RCRA so that CERCLA's lender and fiduciary provisions shall also apply in determining whether a secured creditor is an owner or operator of a UST system under RCRA.[22] However, where those provisions are inconsistent with the 1995 RCRA Lender Liability Rule, the provisions of the rule apply.[23] ■

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22. Id., section 2503(B)
23. Id., section 2503(C)