perfect. But loan officers don't really pay that much attention to the security agreement. They are relying on a particular payment stream—such as the milk proceeds in this case—to get the loans paid. Years may pass with this kind of arrangement. By failing to enforce the requirement in the security agreement that the debtor cannot sell collateral without the bank's permission, the bank waives its right to enforce those terms *ever*. The debtor one day defaults, and the collateral has flown. The message on the requirement that the debtor have the lender's permission to sell collateral is: *Enforce it or lose it.*

Environmental Liabilities

EPA's New Lender Liability Rules: Panacea or Pitfall?

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

The Environmental Protection Agency's proposed rules interpreting the secured creditor's CERCLA exemption from liability for environmental cleanup of properties serving as loan collateral were published June 24th. The proposed rules must undergo public comment before they are officially adopted, but upon publication they became immediately effective as guidance for EPA's own offices. The EPA rules will not be binding on federal or state courts, however, so that lenders could still face uncertainty over their CERCLA liability. Nevertheless, the rules do provide that any plaintiff arguing that a secured creditor is not entitled to the secured creditor's exemption has the burden of proving that argument.

This article analyzes the EPA proposed rules and their likely impact on secured creditors.

Background

The costs for cleaning up properties contaminated with hazardous wastes and other substances are enormous. The CERCLA statute addresses the question of who must pay these costs. It makes all current and past "owners and operators" of a facility or vessel strictly liable for cleanup costs. This means an owner or operator is liable regardless of whether it caused the damage that necessitated the cleanup. CERCLA also imposes joint and several liability, which means *any* single owner or operator can be required to pay the entire cost of a cleanup even though there are many other owners or operators, some of whom bear greater responsibility for the conditions requiring the cleanup. This is often referred to as "deep pocket" liability, meaning the liable party with the greatest resources (deepest pocket) is likely to pay the most.

CERCLA contains a provision that exempts from the definition of owner or operator a lender who "without participating in the management of . . . a facility, holds indicia of ownership primarily to protect. . .a security interest." This is referred to as the "security interest exemption." It is this exemption that the EPA rules are meant to interpret. The exemption is very valuable to lenders; without it, they may be defined as owners and operators of their borrowers' properties and themselves become liable for the often enormous costs of cleaning up those properties.

Court Decisions

Thus far, four federal district courts and two appellate courts have examined the scope of the secured creditor's exemption.

> Two other courts have held that a lender will be liable for cleanup costs if it forecloses on property, regardless of its motive or the length of time it is in the title chain.

On the issue of whether a secured creditor loses its immunity from liability when it forecloses on contaminated property, two courts have found that a lender's acquisition of title through foreclosure is merely incident to protecting a security interest and should not subject a lender to CERCLA liability. Two other courts have held that a lender will be

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liable for cleanup costs if it forecloses on property, regardless of its motive or the length of time it is in the title chain.

On the issue that is even more troublesome for lenders—what constitutes the kind of control that will be considered "participation in the management" of a facility—the cases have failed to establish a clear boundary between a lender's prudent oversight of its borrower's operations and "participation" in the borrower's management to such an extent the lender loses its secured creditor's exemption.

Is the Transaction a Security Interest?

The proposed EPA rules contemplate that EPA can look beyond the "security interest" label on a transaction to determine if it is truly a security interest for purposes of the security interest exemption. If EPA determines that the interest is primarily as an investment rather than to assure payment of a loan or performance of some other obligation, the exemption will not apply. It is unclear how EPA would view a situation in which a lender as part of a restructuring to recoup loan losses became entitled to shares in increased value of property or other debtor assets. Would EPA view the lender as having primarily an investment interest, and thus not entitled to the security interest exemption? This is unknown.

The rule is clear that when a financial institution acts in a non-lending capacity, such as a fiduciary, the secured creditor's exemption does not apply.

Loan Origination Activities

The proposed rule states that certain preloan actions will not be considered evidence of "participating in the management of a facility" that could cause the lender to be stripped of its immunity from environmental liability. Among these allowable activities are requiring the borrower to perform environmental audits prior to loan closing; inserting loan covenants and warranties requiring the borrower to obey environmental laws; and providing financial advice and other guidance about loan structure and terms.

CERCLA's "innocent purchaser" defense only allows landowners to raise a defense to environmental liability if they make an "appropriate inquiry" (in practice this usually means as an environmental audit) into the environmental conditions of the property. The proposed EPA rule states that CERCLA does not mandate that a lender must require or undertake an environmental audit to qualify for the secured creditor's exemption from liability, nor may the creditor be found liable because it did not undertake such an audit. EPA also provides that where the risk of default is slight, a bona fide security holder may knowingly take a security interest in contaminated property without becoming subject to CERCLA liability. CERCLA's requirement for an "appropriate inquiry" seems to be contradicted by EPA's statement that CERCLA does not require the lender to undertake an environmental audit. It is unclear how a court would resolve this apparent conflict. Lenders should be very cautious about waiving any environmental due diligence, such as an audit, especially if they expect to foreclose on the collateral in the event of default.

"CERCLA's requirement for an "appropriate inquiry" seems to be contradicted by EPA's statement that CERCLA does not require the lender to undertake an environmental audit."

Permissible Activities during Loan Administration

The EPA rule broadly states that lenders may take actions during the life of a loan that are consistent with protecting their security interests without incurring liability. Such actions include monitoring the borrower's business; on-site inspections or audits of the borrower's financial or environmental conditions; and enforcement of environmental warranties or covenants. EPA cautions, however, that a lender will cross the line into impermissible activity and risk losing its liability exemption (1) if it exercises such decision-making control over the borrower's environmental compliance that the lender has assumed responsibility for the borrower's handling of hazardous substances, or (2) if it has management control over the borrower, such as by establishing, implementing, or maintaining policies and procedures related to day-to-day environmental compliance.

Permissible Activities during Workouts

In light of some court decisions on lenders environmental liability for borrowers' pollution, many lenders have grown concerned that typical workout actions—such as greatly increased supervision of the borrower—will be construed by courts as participating in the management of the borrower, thus exposing the lender to CERCLA environmental liability.

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EPA's rule affirms that common workout practices will not remove the security holder from the protection of the secured creditor's exemption so long as those activities are taken to help prevent a loan default or diminution of the collateral's value and the secured party does not divest the borrower of its decision-making authority. Actions that should not remove the lender's protection include providing financial advice or similar support to a distressed borrower and restructuring or renegotiating loan obligations so that additional interest is required or payment periods are extended.

The EPA rule includes a caveat, however. It states that when providing advice or otherwise acting to protect its security interest, the security holder should be aware of the presence of hazardous substances on the borrower's property to ensure that its own actions do not contribute to contamination, since a contribution to contamination can subject the lender to CERCLA liability. This would strongly suggest that lenders should conduct an environmental audit before engaging in a workout, or be otherwise assured that they are fully apprised of environmental factors. Furthermore, a lender will have to proceed with extreme caution when deciding whether to comply with a distressed borrower's request for an over-advance for the purpose of funding environmental compliance.

> To establish that the intent is divestiture and the property is held only to protect the security interest, the secured party must comply with various strict procedural requirements.

One remedy sometimes used by borrowers during workouts is to be appointed as a receiver, keeper, or conservator to manage the property of a troubled borrower. The EPA rule does not clarify whether this type of action falls into the class of permissible actions a lender may take during a workout.

Foreclosure

Lenders face their greatest exposure to CERCLA liability when they acquire title to contaminated property through a judicial foreclosure, exercise of a statutory power of sale, or acceptance of a deed in lieu of foreclosure. The proposed EPA rule allows lenders to take possession of property for up to twelve months in connection with a sale or liquidation of the borrower's assets without incurring liability as an owner or operator of the property under CERCLA. But there are some significant restrictions on this limited protection.

For example, the security holder must endeavor to divest itself of the foreclosed property or run the risk that it will be deemed in possession for some purpose other than protection of its security interest. To establish that the intent is divestiture and the property is held only to protect the security interest, the secured party must comply with various strict procedural requirements.

First, the security holder must begin advertising the property on at least a monthly basis in either a trade magazine, real estate journal, or other publication "suitable for the property in question" or in a general circulation newspaper covering the area where the property is located. The EPA defines such a newspaper as one with circulation of more than 10,000 or that the local court deems sufficient for publication.

> If the lender fails to take mitigative or other environmentally responsible actions, it may lose its liability immunity on the foreclosed property.

In addition, six months after foreclosure a secured creditor cannot reject or fail to act within ninety days of receipt of a written bona fide offer for fair consideration for the property. EPA defines "fair consideration" to be an amount equal to or greater than the outstanding principal owed, plus any unpaid interest and penalties, plus reasonable fees incurred by the security holder during the foreclosure period, less any net revenues received by the security holder in continuing operations of the facility or in connection with any partial disposition of the property. Where a lender rejects, outbids, or fails to act on an offer of fair consideration, EPA will presume that the lender is acting for some reason other than to protect its security interest, thus exposing the lender to CERCLA liability.

The EPA rules are silent on whether the secured creditor's exemption continues beyond twelve months if the creditor has made all good faith efforts to sell the property but has received no offers of fair consideration. This is an area that needs clarification.

While a lender is attempting to dispose of a property, it may, without incurring liability, wind up operations, liquidate or sell off assets, or act to recover the value of its security interest in a manner consistent with good commercial practice. EPA says

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that "winding up" operations includes those actions necessary properly and responsibly to close down a facility, secure the site, and otherwise protect the value of the foreclosed asset.

In addition, EPA will require the security holder to take affirmative steps to prevent or minimize the risk of releases or threatened releases of hazardous substances at the facility such as by having drummed wastes removed from the site. This requirement places lenders in a true Catch-22 predicament, because even though such actions would not be deemed participation in the management of the facility, the lender could still find itself saddled with CERCLA liability as a generator or transporter of hazardous substances for wastes sent off-site. If the waste disposal facility where the wastes are sent must be cleaned up, the customers of the disposal facility, including the security holder, could be liable for that cleanup. If the lender fails to take mitigative or other environmentally responsible actions, however, it may lose its liability immunity on the foreclosed property.

Another workout or default remedy sometimes used by lenders is to transfer properties to their subsidiaries or affiliates when foreclosing or taking possession of property. It is unclear under the EPA rules whether the subsidiary or affiliate can be a successor in interest and thus eligible for the secured creditor exemption. Nor do the proposed rules indicate whether the lender will lose its exemption by allowing its subsidiary or affiliate to take possession of or title to contaminated property.

Finally, the EPA rules do not indicate whether a security holder who initially forecloses on property but then does not try to sell the property because it waives its rights or transfers its rights back to the borrower will still be able to assert an exemption from liability.

To be continued next month.

Workouts & Bankruptcy

Workouts, Bankruptcy and Restructurings: Successful Strategies To Restructure Problem Loans

By Barry V. Freeman • Gendell, Raskoff, Shapiro & Quittner • Los Angeles

Editor's note: This article is the second in a multi-part series.

Credit File Review

Immediately upon assignment of a troubled credit to the lender's Loan Adjustment Department (LAD) and/or outside counsel, *all* files related to the loan(s) should be collected in one location and reviewed carefully by appropriate personnel who will appreciate the importance of the material reviewed. The file "roundup" should include related credits for subsidiaries, guarantors, etc., as well as the note files from the note department *and* "personal files" maintained by any officers now or previously involved with the credit. Only a thorough and careful review of each of these files will reveal potential borrower claims and allegations and enable them to be evaluated. Often loan officers' "personal files" will contain notes of conversations and statements that could be helpful (or harmful) in the event of litigation. Unless these files are collected in one location and meticulously reviewed, potential damaging evidence will be unknown, leading to possible adverse consequences when these documents are later produced.

Often loan officers' "personal files" will contain notes of conversations and statements that could be helpful (or harmful) in the event of litigation.

This kind of careful file review and complete evaluation of the credit can be costly, but it can

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