ENVIRONMENTAL INSPECTIONS BECOME A NECESSITY FOR LENDERS IN THE USA

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Recent federal judicial decisions holding lenders liable for the clean-up obligations of their borrowers have made financial institutions increasingly tempting targets in the $100 billion battle over who will pay for the clean-up of America's hazardous waste-disposal sites.

In order to minimize their potential liability and to take advantage of defences to liability available in state and federal environmental clean-up laws, it is essential that lenders conduct detailed environmental investigations before extending credit to prospective borrowers, advancing loans to financially-troubled debtors or foreclosing on defaulted mortgages. These examinations should be conducted for industrial sites — and commercial properties with gasoline stations, dry cleaners, jewellers, paint operations and high-tech companies —since these businesses all use hazardous chemicals. Farmland, ranches or vacant lots near old dumps should also be investigated since they can present environmental liability because of a prior use of the property or of adjacent parcels.

FEDERAL ENVIRONMENTAL LAW

The 1986 amendments to the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), which is commonly known as "Superfund", obligates landowners to conduct an environmental audit of property to be acquired, or face liability if contamination is subsequently discovered. Under Superfund, owners and operators of a facility or vessel (ie equipment, containers) are liable for the removal and clean-up costs associated with releases or threatened releases of hazardous substances into the environment. This liability extends to past owners of a site who were responsible for the discharge as well as current owners who acquired title after the original discharge. While Superfund generally exempts holders of security interests in contaminated properties from liability for clean-up costs, lenders may lose their immunity if they participate in the management of the facility or if they acquire title to the contaminated property through foreclosure.

To mitigate the harsh impact that Superfund has on lenders and landowners, the 1986 amendements provided an "innocent purchaser's" defence. A landowner which acquires contaminated property will not be liable for the clean-up costs if it can establish that it did know or had no reason to know that the property was contaminated at the time the property was acquired. To utilize this defence, however, the landowner must conduct an "appropriate" inquiry into the previous ownership and use of the property that is consistent with "good commercial or customary practice". In creating this defence, it is clear that the United States Congress intended to establish a standard of conduct for purchasers of property and it appears that this defence will not be available to lenders unless they conduct an environmental inspection prior to foreclosing or acquiring property.

STATE ENVIRONMENTAL LAW

Many states have laws requiring sellers to notify buyers of the presence of hazardous substances on property and to record such information in public records. Other states encourage inspections by imposing "Superliens" on contaminated property. While these "Superlien" laws differ in scope, they generally provide that the clean-up costs incurred by state environmental authorities shall become a first-priority lien against the contaminated property, which is superior to previously recorded mortgages or perfected security interests.

However, the most far-reaching environmental law is the New Jersey Environmental Cleanup Responsibility Act (ECRA), which mandates an inspection and clean-up, if necessary, of industrial establishments before the facilities can be sold, transferred or closed. The law not only imposes substantial clean-up obligations on the parties in a transaction but can create delays in completing deals. It can also prolong the exposure of lenders in certain situations and make lenders liable for clean-ups should they foreclose and sell property subject to ECRA. However, it can protect lenders from hidden environmental liability and, as a result, many lenders in New Jersey will not approve financing until the prospective borrower either demonstrates compliance with ECRA or obtains a "Non-Applicability" letter from the state environmental agency indicating that ECRA does not apply to the pending transaction.

Industrial establishments do not have to comply with ECRA until there is an "ECRA transaction" — a proposed transfer or closing of an industrial establishment. Once this triggering event occurs, the owner or operator of an industrial establishment must notify the New Jersey Department of Environmental Protection (NJDEP) before closing or trans-

ferring the facility, and submit either a clean-up plan to de-toxify the plant or file a "negative declaration" that states there has been no discharge of hazardous substances at the facility.

The state has to approve the clean-up plan or the negative declaration before the operation can be closed or ownership transferred. The owner or operator of an industrial establishment that fails to comply with ECRA will be strictly liable for any clean-up costs, may be fined up to $25,000 per day and the transaction can be declared void.

ECRA has been bitterly criticized by commercial and real estate interests in New Jersey who claim that unclear regulations and processing delays have unnecessarily complicated and tied up commercial transactions across the state. The NJDEP recently adopted new regulations to streamline the administration of the law and resolve ambiguities, but the changes did not satisfy the business groups and they have begun a legislative effort to amend the law significantly.

One of the biggest criticisms of the ECRA regulations has been that they do not specify what business transactions constitute "ECRA transactions". ECRA not only encompasses transactions involving the sale of land but can also include sales of the controlling assets of the industrial establishment, stock transfers that affect the ownership of the industrial establishment, dissolution of corporate identity and corporate re-organizations. In addition, the transaction that does trigger compliance does not have to occur in New Jersey. For example, if a New York corporation that operates a facility in New Jersey is purchased by a California corporation, ECRA will apply because of the change in ownership of the New Jersey facility.

The new guidelines that went into effect on 1st January did describe in greater detail the transactions that were covered by ECRA and the business activities that were exempt. Thus, under the new rules, the execution of a long-term lease, the termination of an existing leasehold or the filing of certain bankruptcy petitions will require an ECRA review, but the execution of a mortgage, the filing of a lien or a testamentary transfer of the ownership of a company will not trigger ECRA. In addition, the regulations also provide that a landlord may be liable for the contamination caused by a tenant.

However, the business interests have criticized the new rules because they virtually eliminate the exception for transactions that do not affect the ownership of the industrial establishment.

Under the old regulations, an industrial establishment would have to seek ECRA approval only if there was a transfer of at least 51% of its stock or the stock of a corporation owning the facility. Under the new guidelines, however, a transfer of a minority interest will trigger ECRA review if that is the controlling interest of the industrial establishment or corporate owner. Thus, it is conceivable that a chief executive officer holding less than 10% of the stock of the indutrial establishment could single-handedly trigger ECRA by selling his shares.

A similar problem arises when the sales of assets are involved. A sale or transfer of more than 50% of the assets of the industrial establishment which is not in the ordinary course of business will trigger ECRA. Under the new rules, a transfer of assets to an affliate or the sale of out-of-state warehouses containing more than 50% of the industrial establishment's assets require ECRA approval.

Another major problem area has been whether an industrial establishment can sell a "clean" portion of its plant without having to do a complete ECRA review on the entire facility. Originally, the NJDEP required an industrial establishment to obtain approval to transfer or close a non-commercial property, such as an office building, even if that property was located in a different part of the state.

After vehement protests, the agency subsequently agreed that parcels of land not physically attached to the manufacturing site could be transferred without triggering ECRA so long as the primary business activity at the site was not one that was covered by ECRA. However, the NJDEP still required ECRA approval if the non-commercial property was attached to the manufacturing facility, even if the land being sold was farmland.

Under the new rules, an industrial establishment can sell up to 20% of its appraised value without having to conduct an ECRA review, so long as the property conveyed has never been involved with hazardous wastes.

EXTENT OF CLEAN-UP REQUIRED

Finally, the new regulations did not address the issue that is of paramount concern to the ECRA critics: what level of clean-up is acceptable to the state?

ECRA critics attribute much of the processing delays to an absence of uniform clean-up standards. Without such standards, it is difficult to develop clean-up plans that are acceptable to the state and when a clean-up is rejected, it must be resubmitted before the transaction can be completed. The NJDEP has developed "minimum action levels", but they vary from site to site because of differing groundwater and soil conditions, and the agency insists that it must proceed on a case-by-case basis.

Several states, including New York, have considered ECRA legislation, but those efforts have stalled because of the delays and confusion encountered in New Jersey and, thus far, Connecticut has been the only other state to adopt such a law. The Connecticut law is much less restrictive, however, and only requires state approval when a clean-up is necessary. A negative declaration must be prepared for uncontaminated property but the property can still be transferred before the negative declaration is filed. In addition, if a clean-up is necessary, it is the purchaser and not the seller who is responsible for compliance.

ECRA is definitely the wave of the future in environmental legislation, but the final form of such future legislation will probably have to await the battle over the bill to amend ECRA that was introduced into the New Jersey legislature earlier this year. □