*Environmental Issues*

# Lender Liability Today Under Environmental Laws

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## I. Introduction

Environmental issues present three basic types of risks to creditors: Credit Risk; Direct Liability Risk; and Reputational Risk.

- Credit Risk: This concern has two components. First, lenders are concerned that environmental issues may impact the cash flow of the borrower and affect its ability to repay the loan. The second concern within this risk category is impairment of collateral value from contamination or other environmental liability such as asbestos, lead-based paint, mold, or lead in drinking water.

- Direct Liability: This is the risk that a lender will be held liable for cleanup costs or toxic torts (*i.e.*, for personal injury or property damage claims from hazardous substances).

- Reputational Risk: Lenders do not want to be associated with property that may be stigmatized or that poses a risk to the local community.

The type of creditor that is involved in a particular transaction as well as the nature of the transactions also may influence the level of concern for environmental issues. Factors that could influence sensitivity to environmental issues include whether the creditor is a:

- Community bank, regional or money center bank, or investment bank;

- traditional mortgage lender, loan syndication, or securitization;

- asset-based lender versus a balance sheet loan facility;

- lender or other creditor as opposed to an equity investor; and

- whether the transaction was a refinance or a new loan.

According to a survey conducted by Environmental Data Resources Inc. (EDR) in 2003, one out of every ten banks involved in commercial estate loans had experienced losses due to environmental issues within the past year. The environmental-related losses involved an average of two loans per year and the average total loss was $1.2 million. Based on the number of banks involved in commercial real estate transactions, EDR said the survey meant that 900 banks may have experienced losses due to environmental issues during the preceding twelve months and that the total value of these defaulted loans could be $1.11 billion.

The EDR survey found that the smallest banks had the highest incidence of environmentally-related losses. Lenders with assets less than $1 billion (mainly community and smaller regional banks) experienced almost seventy-five percent

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of the loan losses due to contamination. Forty-three percent of all lenders having less than $250 million in assets reported that they suffered losses from environmental issues. The total loss experienced by banks in this asset category was $473 million. In contrast, twenty-nine percent of banks with assets between $250 million and $1 billion experienced a total of $319 million in loan defaults because of environmental issues. Banks in the $1 billion to $10 billion asset category represented twenty-eight percent of the respondents and experienced the lowest total loss at $308 million.

EDR concluded that the reason the smaller banks suffered disproportionate environmental-related losses was because they tend to perform less comprehensive environmental due diligence and also because smaller borrowers had a greater tendency to walk away from contaminated sites since the cleanup costs often exceed the amount of the equity invested in the property. The smaller banks typically do not have in-house environmental expertise, have not developed environmental risk management policies, have not established minimum due diligence requirements, and often simply accept phase I environmental site assessments (ESAs) performed by consultants who have been retained by the borrower and whom the banks have not pre-qualified.

EDR also indicated that the survey confirmed that the majority of banks perform environmental due diligence in order to mange risk and not because of concerns over liability. As a result, many lenders have developed their own environmental due diligence protocols that often exceed the ASTM E1527-00 standard for Phase I ESAs. These so-called ASTM-Plus protocols often require consultants to examine issues not addressed by the ASTM E1527-00 standard, such as asbestos, lead-based paint, lead in drinking water, radon, and mold.

This article will review the scope of the liabilities that lenders may face under federal and state environmental laws.

## II. Overview of Lender Liability Under CERCLA and RCRA

### A. Introduction

The two environmental laws of greatest concern to lenders are the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)[1] and the federal Resource Conservation and Recovery Act (RCRA).[2] These laws contain secured creditor exemptions that provide a safe harbor to protect lenders from liability for the cleanup of contaminated property. The exemptions can provide liability protection to secured creditors during the administration of a loan (including workouts) as well as during foreclosure and post-foreclosure.

It should be noted that the CERCLA and RCRA secured creditor exemptions do not provide relief from liability under other federal laws such as those governing the cleanup of polychlorinated biphenyls (PCBs) or for complying with the lead-based paint (LBP) disclosure rules promulgated under the Toxic Substance Control Act.[3] Similarly, the CERCLA and RCRA secured creditor exemptions do not provide any liability relief for state or common law claims.

### B. CERCLA

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.[4]

The federal government is authorized to perform cleanups known as response actions,[5] and then may seek to recover its costs against PRPs.[6] The federal government also may seek injunctive relief ordering PRPs to perform response actions for releases of hazardous substances that pose "imminent and substantial endangerment" to human health or the environment.[7] Private parties and states that incur response costs may also seek to recover those costs either in cost recovery actions[8] or contribution actions.[9]

There are three affirmative defenses to CERCLA liability:

- Act of War;
- Act of God; and
- The Third Party Defense.[10]

The most commonly asserted defense is the third party defense. To qualify for this defense, a defendant must establish the following four elements:

- The release was caused solely by the act or omission of a third party;
- with whom the defendant had no direct or indirect contractual relationship;
- that the defendant exercised due care with respect to the

1. 42 U.S.C. §§ 9601 *et seq.*
2. 42 U.S.C. §§ 6901 *et seq.*
3. 15 U.S.C. §§ 2601 *et seq.*
4. 42 U.S.C. § 9607(a)(1)-(4).
5. *Id.* § 9604.
6. *Id.* § 9607.
7. *Id.* § 9606.
8. *Id.* § 9607(a)(4)(A)-(D).
9. *Id.* § 9613(F).
10. *Id.* § 9607(b).

hazardous substances ("the due care element"); and

- that the defendant took precautions against the foreseeable acts or omissions of any such third parties ("the precautionary element").[11]

Because a lease or purchase agreement could be considered a "contractual relationship," initially the third party defense was largely unavailable to purchasers or tenants of contaminated property. As a result, Congress enacted the innocent purchaser defense in 1986. Under this defense, a purchaser who "did not know [and] had no reason to know" of contamination would not be liable as a CERCLA owner or operator.[12] To establish that it did not know or have reason to know of the contamination, the party must have conducted an "appropriate inquiry" into the past ownership and uses of the property.[13]

Many courts have narrowly construed the innocent purchaser's defense. In most cases, if a purchaser did not discover contamination prior to taking title but contamination is subsequently discovered, the court will conclude that the purchaser did not conduct an adequate inquiry and, therefore, is not eligible for the defense.

Note that because the innocent purchaser defense is technically a part of the third party defense, a landowner seeking the innocent purchaser defense would have to satisfy the due care and precautionary elements of the third party defense as well.

In 2002, Congress added a Bona Fide Prospective Purchaser (BFPP) Defense and Contiguous Property Owner (CPO) defense[14] to CERCLA as part of comprehensive amendments to the law that became effective on January 11, 2002.[15] Under the BFPP, a purchaser may knowingly acquire contaminated property and not be liable for remediation if it satisfies nine conditions.[16]

The CERCLA secured creditor exemption was originally enacted out of a concern that persons who held mortgages for security of loans or other obligations in so-called "title-theory" states would be treated as CERCLA owners or operators while the mortgage was in effect. In these states, where the common law of mortgages applies, a mortgagee actually holds title to the property.[17] The legislative history of CERCLA did not provide any guidance on the types of permissible activities that would be considered to be consistent with the exemption.

The secured creditor exemption received little attention until the late 1980s when a series of conflicting decisions created much uncertainty in the financial community as to the scope of the protection and what actions secured creditors could take without losing their immunity to liability. This uncertainty took on a particular importance for the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC), in acting as conservators and receivers of failed insured depository institutions under the Federal Institutions Reform, Recovery and Enforcement Act (FIRREA).[18] The FDIC and RTC became concerned that when they were appointed as receiver or conservator an of insolvent financial institution, they could take title to or have a security interest or mortgage in contaminated properties that were in the portfolios of the failed lender. The limits of the CERCLA exemption also posed a risk to other governmental agencies such as the Small Business Administration (SBA) who could acquire interests or possession of a diverse range of businesses, properties, and assets that might include contaminated properties.[19]

As a result, the Environmental Protection Agency (EPA) promulgated a CERCLA Lender Liability Rule in 1992.[20] After that rule was invalidated, Congress enacted the Asset Conservation, Lender Liability and Deposit Insurance Protection Act (1996 Lender Liability Amendments) to substantially amend the secured creditor exemptions of CERCLA and RCRA.[21] The 1996 Lender Liability Amendments added new defined terms and identified the kinds of actions lenders could take without being considered to be participating in the management of a facility as well as the steps that lenders had to follow in foreclosing on property in order to be considered simply engaged in protecting their security interest. Congress made it clear that the 1996 Lender Liability Amendments did not create any liability but instead limited liability that might otherwise be present.[22]

As a result, the CERCLA secured creditor's exclusion operates to exclude from the definition of "owner or operator" any person who "holds indicia of ownership primarily to protect the security interest" in a vessel or facility and provides that this person will not be liable as an owner or operator if the person does not "participate in the management" of the facility or vessel.[23] This exemption can insulate a secured creditor from liability during the administration of a loan including workouts, so long as the lender's actions during the life of a loan do not constitute the exercise managerial of control over the operations of its borrower.

11. *Id.* § 9607(b)(3).

12. *Id.* § 9601(35)(A).

13. *Id.* § 9601(35)(B). It is this requirement to perform an appropriate inquiry that is the source of the environmental due diligence that is now customarily performed in real estate, corporate, and financial transactions.

14. 42 U.S.C. § 9607(q).

15. Small Business Liability Relief and Brownfield Redevelopment Act, P.L. 107-118.

16. 42 U.S.C. § 9607(r).

17. *See* House Debate on H.R. 85, 96th Cong., 1st. Sess. (1979) (Sept. 18, 1980), *reprinted in* 2 A Legislative Report of the CERCLA, Senate Comm. On Environmental and Public Works, 97th Cong., 2d Sess., 889, 945 (Comm. Print 1983).

18. P.L. 101-73 (Aug. 9, 1989).

19. 56 Fed. Reg. 28799 (June 24, 1991).

20. 57 Fed. Reg. 18344 (April 29, 1992). This rule was vacated by the Court of Appeals for the District of Columbia in 1994 in Kelly v. EPA, 15 F.3d 1101 (D.C. Cir. 1994). On December 11, 1995, the EPA and the Department of Justice announced that they would enforce the provisions of the 1992 CERCLA Lender Liable rule that had been invalidated by the DC Circuit. *See* 60 Fed. Reg. 63517 (Dec. 11, 1995).

21. Omnibus Consolidated Appropriations Act of 1997, P.L. 104-208 §§ 2501-2505, 110 Stat. 3009 (Sept. 30, 1996).

22. 42 U.S.C. § 9607(n)(6)(B).

23. 42 U.S.C. § 9601(20)(E)(i).

The exemption also provides limited protection to lenders during foreclosure.[24] While noting some foreclosure and post-foreclosure issues and cases, this article focuses on the pre-foreclosure activities that are permissible under the secured creditor exemption rather than what a lender has to do to comply with the foreclosure requirements of the secured creditor exemption.

### C. RCRA

RCRA regulates the generation, storage, handling, transportation, and disposal of hazardous waste. Owners or operators of facilities that treat, store, or dispose of hazardous wastes (TSDF) must comply with certain operating standards and also may be required to undertake corrective action to clean up contamination caused by hazardous or solid wastes. The corrective action requirements may be contained in a permit.[25] The federal government or a state authorized to adminster RCRA may also issue a corrective action order to an owner or operator of TSDF generator of hazardous waste to subject to RCRA.[26] The government also may issue orders for injunctive relief to address hazardous wastes posing an "imminent and substantial endangerment" to public health and the environment.[27] In addition, private parties may seek injunctive relief to compel remedial action by persons who contributed to the past or present handling, storage, treatment, transportation, or disposal of hazardous waste that is posing or "imminent and substantial endangerment" to public health and the environment.[28] However, unlike CERCLA, private parties are not entitled to recover their cleanup costs.

The RCRA secured creditor's exemption is similar to the CERCLA provision but is limited to underground storage tanks (USTs). In 1995, the EPA issued guidance interpreting the scope of the RCRA secured creditor exemption.

As amended by the 1996 Lender Liability Amendments, 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:

- the indicia of ownership is held primarily to protect a security interest;
- the lender does not participate in the management of the UST system; and
- the lender is not engaged in petroleum production, refining, or marketing.[29]

The RCRA secured creditor exemption specifically incorporates the definitions and other requirements contained in the CERCLA secured creditor exemption, establishing when a lender will not be considered an owner or operator of a facility, except that RCRA only applies to a lender's potential liability as an owner or operator or an underground storage tank. The RCRA secured creditor exemption will not insulate a lender from liability as an owner or operator of a RCRA TSDF or at a generator-only facility.[30]

In addition, the RCRA secured creditor exemption provides that to the extent it is inconsistent with any provisions of the RCRA UST Lender Liability Rule, the provisions of that rule will prevail.[31]

The RCRA secured creditor exemptions do not insulate lenders from liability under other provisions of RCRA such as the citizen-suit provision of section 7002.[32] This section allows suits to be brought 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. For this purpose courts have broadly interpreted the phrase "contributed to." In *Citizens Bank and Trust Company vs. MidSouth Rail Corp*,[33] a state court in Mississippi relied on similar language appearing in the Mississippi superfund law to hold a bank liable for contributing to environmental conditions at its borrower's facility. The court said that by extending financing to a company that the lender knew was mishandling hazardous materials on its property, the bank had contributed to the creation of the problem.

### D. Key Definitions of the CERCLA/RCRA Secured Creditor Exemptions

Before analyzing the scope of the secured creditor exemptions, it is important to review some of the key definitions. These terms apply to both the RCRA and CERCLA secured creditor exemptions.

#### 1. Lender

The secured creditor exemption applies to a broad range of traditional lending institutions[34] as well as any person who:

24. A lender will not be considered a CERCLA owner or operator if it did not participate in the management of a facility prior to foreclosure, or foreclosures on the facility or vessel, and then follows certain requirements. After foreclosure, the lender may maintain business activities, wind up operations, undertake a response action in accordance with the NCP or under the direction of an on-scene coordinator, or otherwise take any other actions to preserve, protect or prepare the vessel or facility prior to sale or disposition *provided* the lender tries to sell, release, or otherwise divest itself of the facility or vessel at the earliest practicable, commercially reasonable time, and on commercially reasonable terms after taking into account market conditions and legal or regulatory requirements.

    42 U.S.C. § 9601(20)(E)(ii). *See also infra*: Pt.II.D.4., at note 46; Pt.II.E., F.; and Pt.X.A.

25. 42 U.S.C. § 6924(u) and (v).

26. *Id.* § 6938(h).

27. *Id.* § 6973.

28. *Id.* § 6972(a)(1)(B).

29. 42 U.S.C. § 6991(b)(h)(9).

30. *Id.* § 6991(b)(h)(9)(B).

31. *Id.* § 6991(b)(h)(9)(C).

32. 42 U.S.C. § 6972.

33. No. 30,011 (Ch. Div. Rankin Cty. Miss. Mar 18, 1994).

34. These include an insured depository institution, an insured credit union, a bank or association chartered under the Farm Credit Act, a leasing or trust company that is an affiliate of an insured depository institution as well as the Federal National

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- makes a bona fide extension of credit to or takes a security interest from a person not affiliated with the lender;

- insures or guarantees against a default in the repayment of an extension of credit or who acts as a surety for an extension of credit to a person not affiliated with the lender; or

- provides title insurance and acquires a vessel or facility as a result of an assignment or conveyance in the course of underwriting claims and claim settlements.[35]

### 2. Indicia of Ownership

The legislative history indicated that the purpose of the exemption is to protect lien holders in states where mortgagees are considered to have title to the property subject to the security interest. However, in its CERCLA Lender Liability Rule, the EPA defined the term "indicia of ownership" more broadly so that it applies to all lenders regardless of whether they are located in a "title-theory" or "lien-theory" jurisdiction. Under the EPA definition, it is not necessary for a person to actually hold title in order to maintain "indicia of ownership." Instead, the term is defined as evidence of a security interest or evidence of an interest in real or personal property securing a loan or other obligation including equitable or legal title in real or personal property acquired incidental to foreclosure or its equivalents. Examples of indicia of ownership set forth in the regulation include mortgages, deeds of trusts, surety bonds, guarantees of obligations, title held pursuant to a lease financing transactions, assignments, pledges, and other forms of encumbrances against property that are held primarily to protect a security interest.[36]

The 1996 Lender Liability Amendments did not contain a definition of indicia of ownership, so this term remains undefined in CERCLA and RCRA. The EPA has reinstated its CERCLA Lender Liability Rule as an enforcement policy. Thus, for purposes of regulatory enforcement, the EPA definition applies. In addition, a court in a private contribution or cost recovery action might find the EPA interpretation of this term persuasive, even though EPA's definition is not derived from the statute and would not be binding in private litigation.

### 3. Security Interest

This term includes a right under a mortgage, deed of 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, performance of a duty, or any other obligation by a non-affiliated person.[37]

### 4. Participation in Management

A lender holding indicia of ownership primarily to protect a security interest in a facility or vessel will not be liable as a CERCLA owner or operator during the term of the loan if the lender does not participate in the management of that facility. In its CERCLA Lender Liability Rule, the EPA concluded that the lender must have exercised actual daily control over the operational affairs of the vessel or facility in order to be deemed to have participated in the management of the borrower.[38] The EPA indicated that the term "participation in management" does not refer to a lender who merely has the capacity to influence the operations of a borrower's facility or vessel or has an unexercised right to control the vessel or facility operations.[39] Thus, the mere presence of clauses in a financing agreement giving a lender the right to take certain action such as responding to violations of law or releases of hazardous substances will not expose the lender to liability.[40] The 1996 Lender Liability Amendments adopted this interpretation.[41]

A lender who holds "indicia of ownership primarily to protect a security interest" may be considered to "participate in management" if it does any of the following while the borrower is in possession of the property encumbered by the security interest:

- Exercises decision-making control over the borrower's environmental compliance, such that the lender has undertaken responsibility for the borrower's hazardous substance handling or disposal practices; or

- exercises control at a level comparable to that of a manager of the facility or vessel so that the lender has assumed or manifested responsibility for the overall management of the day-to-day decision-making at the facility with respect to environmental compliance, or overall or substantially all of the operational functions of the facility or vessel.[42]

The 1996 Lender Liability Amendments added a list of nine permissible activities commonly taken by lenders that are considered consistent with the exemption and therefore do not constituent "participation in management." A lender may take the following nine actions and

34. *(Continued from previous page)*

Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Agricultural Mortgage Corporation, or any other entity that is a bona fide manner buys or sells loans or interests in loans. 42 U.S.C. § 9601(20)(G)(iv)(I)-(IV), (VI).

35. 42 U.S.C. § 9601(20)(G)(iv).

36. 40 CFR § 300.1100(a).

37. 42 U.S.C. § 9601(20)(G)(vi).

38. 57 Fed. Reg. 18359 (April 29, 1992).

39. *Id.*, at 18375.

40. *Id.*, at 18357.

41. 42 U.S.C. § 9601(20)(F).

42. *Id.* § 9601(20)(F)(ii).

not be deemed to have participated in management:

- Holding, releasing, or abandoning a security interest;
- including environmental compliance covenants, warranties, or other environmental conditions in a security agreement or extension of credit;[43]
- monitoring or enforcing any terms or conditions of a security agreement or extension of credit;
- monitoring or undertaking any inspections of the collateral;
- requiring the borrower to take response actions to address releases of hazardous substances;
- providing financial or other advice or counseling to mitigate, prevent, or cure default or diminution of the value of the collateral;
- restructuring, renegotiating, or otherwise agreeing to altering terms and conditions of a security agreement or extension of credit;
- exercising forbearance of any rights;
- exercising any remedies that may be available under applicable law for breaches of security agreements or extensions of credit; and
- conducting a response action under CERCLA in accordance with the National Contingency Plan or under the direction of an on-scene coordinator.[44]

Although CERCLA contains provides criteria for determining if a lender's actions are consistent with the exemption, courts still have to apply the criteria to the particular facts of a case. For example, in *Z & Z Leasing Inc. v. Graying Reel, Inc.*,[45] the owner of a contaminated site brought a contribution action against a bank that held a mortgage on the property. The plaintiff had obtained bond financing to build a new facility and obtained a letter of credit from a predecessor of Comerica Bank. The plaintiff executed a Reimbursement Agreement for any amounts paid under the letter of credit and granted security interests on its assets as well as the mortgage. Six years later, an environmental consultant retained by the bank discovered contamination associated with USTs and the borrower then defaulted on its bond payment.

After the bank filed a civil action to seek a judgment as to the funds it paid under the letter of credit, the borrower entered into a settlement agreement agreeing to maintain the property and comply with environmental laws. The bank also provided the plaintiff a loan to remove the USTs. The machinery and equipment of the borrower were sold and the bank extended the payment period for the remaining balance. The plaintiff failed to make any payments and filed a contribution action against the bank and the former owner, and a malpractice action against its law firm. The plaintiff argued that the bank was liable as an owner and an operator because the plaintiff had effectively transferred financial management of its operation to the bank when it executed the Reimbursement Agreement.

The agreement contained a number of negative covenants prohibiting the borrower from amending operative documents, merging or selling assets, incurring indebtedness, guarantying obligations, purchasing assets or stocks, creating or incurring liens, making loans, purchasing or leasing fixed assets, purchasing or acquiring its capital stock, declaring or paying dividends, purchasing securities, or making investments without approval of the bank. The district court granted summary judgment to the bank on all counts, holding that the bank was not liable as an owner because a mortgagee does not have title to the property in Michigan and that the negative covenants did not amount to participation in management. The court noted that banks frequently have routine involvement in the financial affairs of their borrowers to ensure that their security interests are adequately protected, and to impose liability on the bank in these circumstances would punish it for engaging in the normal course of business. The court said that a secured creditor must be permitted to monitor any aspect of its borrower's business relating to the protection of its security interest without incurring liability.[46]

Similarly, in *U.S. v. Wallace*,[47] the operator of a waste treatment and disposal facility challenged a consent decree proposed by the federal government resolving the liability of other PRPs at the site. The defendant claimed that the SBA should not be allowed to enter into the settlement because it had participated in the financial management of the site to a degree suggesting that it had actual or potential ability to influence or control hazardous waste disposal decisions. The defendant argued that the following were evidence that the SBA had participated in management of the facility. The SBA: had hired financial and technical consultants; had authority to limit capital expenditures on new waste treatment equipment; could limit certain employee raises and bonuses; had to approve

43. An extension of credit includes a finance lease transaction where the lessor does not initially select the leased vessel or facility, and during the term of the lease does not control the daily operation or maintenance of the vessel or facility, or where the transaction conforms with regulations issued by a federal banking agency, an appropriate state bank supervisor ,or with regulations promulgated by the National Credit Union Administration Board. 42 U.S.C. § 9601(20)(G)(i).

44. *Id.* § 9601(20)(F)(iv).

45. 873 F.Supp. 51 (E.D.Mich. 1995).

46. The court also said that requiring the borrower to comply with environmental laws, agreeing to advance the money for the UST cleanup, and requiring the cleanup to comply with the environmental laws as a condition of the Settlement Agreement did not constitute participation in the environmental aspects of the operation.

47. 893 F.Supp. 627 (N.D.Tex. 1995).

dividends to shareholders; and had authority to control voting shares of stock. However, the court said that a reservation of certain rights to protect its investment, monitoring any aspects of a debtor's business, and involvement in occasional and discrete financial decisions relating to the protection of its security interest does not rise to the level of participating in management. Accordingly, the court approved the settlement resolving the alleged liability of the SBA.

In a 2004 case, a federal district court found that a bank might be liable under CERCLA and RCRA because of its involvement in a borrower's operations following a default. In *XDP, Inc. v. Watumull Properties Corp.*,[48] Hong Kong & Shanghai Banking Corporation (Hong Kong) financed the acquisition of a manufacturing business in October 1986. The loan was secured by a mortgage and liens on equipment and fixtures. After the borrower had defaulted, Hong Kong entered into an asset purchase agreement in May 1989 in lieu of foreclosure, wherein the bank took title to the property in an "as is" condition and assumed certain liabilities. Hong Kong then transferred the assets to a newly created subsidiary, MPI, to operate the business. In May 1991, MPI sold the property to another Hong Kong subsidiary, XDP. The bank also created a third subsidiary, Tayside, as the parent of XDP. After contamination was discovered, XDP filed contribution claims against various predecessors who filed cross-claims against Hong Kong as an operator or successor of the responsible parties. The parties asserted that Hong Kong's corporate veil should be pierced because it had inadequately capitalized its subsidiaries, had not adhered to corporate formalities, and had commingled the accounts and properties of its subsidiaries. Hong Kong asserted that it was entitled to the secured creditor exemption because it never participated in the management of MPI and that XDP made commercially reasonable efforts to sell the property. However, based on the totality of the facts, the court concluded that there was a question of fact as to whether Hong Kong was merely protecting its security interest or was controlling and managing the facility from 1989 to 1995 when the property was sold to the general manager and CEO of MPI. The court said there was sufficient evidence for a reasonable finder of fact to conclude that the bank formed the subsidiaries as sham corporations in order to evade liability.

The *XDP* court pointed out that the sole director, president, and secretary of XDP was also the manager of Hong Kong's Portland office, and was the only employee of XDP, that his salary was paid by Hong Kong, and that he did not receive any compensation for serving in official XDP capacities. The court also found that XDP did not have its own office, and relied on Hong Kong's accountants in the Portland office to maintain its records. In 1991, XDP's net interest income was a negative $22 and its operating income was $58. Likewise, Tayside was found to have no business except to serve as a holding company for XDP. In addition, Tayside sent and received faxes from Hong Kong's Nassau office and the bank's legal counsel prepared documents for Tayside even though the company was not his client. The court also found that Tayside received and owed more than $1 million in loans to Hong Kong and that the loans were listed as assets on Tayside's records.

The court also noted that MPI allegedly sold the property to XDP because Hong Kong was considering selling the assets of MPI and wanted to isolate the environmental liabilities in XDP. The court also found that there were material issues of fact as to whether Hong Kong could be liable as a successor. The court observed that after the acquisition, MPI continued to use the same facility, with substantially the same workforce, machinery, equipment, methods of production, name, logo, and product as well as the same customer base. The court found that Hong Kong might also be liable as a successor because it had agreed to assume all liabilities and obligations related to the XDP property.

48. 2004 WL 1103023 (D.Or. 2004).

### 5. Financial or Administrative Functions

A lender may engage in financial and administrative actions during the life of a loan without being deemed to be an owner or operator under CERCLA. Examples of financial or administrative functions set forth in the secured creditor exemption include actions performed by a credit manager, accounts payable officer, accounts receivable officer, personnel manager, comptroller, or a chief financial office.[49]

### 6. Primarily to Protect the Security Interest

This term was undefined in the original versions of RCRA and CERCLA. The EPA provided its own interpretation of that phrase when it proposed the CERCLA Lender Liability Rule in 1991. The agency said the primary purpose of the security interest must be to secure repayment of money, the performance of a duty, or some other obligation, and does not include interests in the nature of an investment in the facility or an ownership interest held for any other reason other than to protect a security interest.[50] Nevertheless, the EPA did recognize that lending institutions have revenue interests in their loans so the mere fact that a secured creditor derives some profit or income from the transaction will not cause the lender to forfeit its immunity, so long as the security interest is primarily to secure repayment of a loan or performance of some obligation.[51] The agency said the protection of a security interest does not necessarily have to be the sole reason for the transaction. If a person holds indicia of ownership in a facility primarily for investment purposes as opposed for assuring repayment of a loan or as security for some other

49. 42 U.S.C. § 9601(20)(G)(ii). An "Operational function" is defined as functions performed by a facility or plant manager, operations manger, chief operating officer, or chief executive officer. *Id.* at § 9601(20)(G)(v).

50. 56 Fed. Reg. 28802 (June 24, 1991).

51. *Id.*

obligation, the EPA said the exemption would not apply.[52]

The CERCLA Lender Liability Rule promulgated in 1992 indicated that the lender's motivation was irrelevant for purposes of determining whether it "participated in the management of a facility" but was relevant in determining why the lender held its indicia of ownership.[53] The EPA went on to say that the fact that a lender has a secondary reason for holding the security interest (*e.g.*, an investment purpose) would not void the exemption.[54] Thus, a secured creditor can still generate profits such as interest and fees without forfeiting its immunity from liability so long as the lender's primary purpose was to protect its security interest.

The 1996 Lender Liability Amendments do not contain a definition of "primarily to protect a security interest." However, while this term remains undefined in CERCLA and RCRA, the EPA has reinstated its CERCLA Lender Liability Rule as an enforcement policy. Thus, for purposes of federal regulatory enforcement, the EPA definition would apply. Again, a court in a private contribution or cost recovery action might find the EPA's interpretation of this term persuasive though the EPA's definition is not statutory and would not be binding on the court.

### E. Foreclosure

The 1996 Lender Liability Amendments added a new 42 U.S.C. section 9607(20)(E) that addresses foreclosure. Like the CERCLA Lender Liability Rule, the new subsection allows financial institutions to foreclose, release (in the case of a sale/leaseback transaction), or sell the 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."

This provision does not contain the "bright-line test" that was contained in the CERCLA Lender Liability Rule. This test required the lender to list the property within a certain period of time and to accept offers for "fair consideration." Lenders who 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 protections of the exemption.

In the absence of such a bright-line test, lenders will not know for certain if their actions are consistent with the exemption and may find themselves subject to subsequent 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 reasonable 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.

### F. Post-Foreclosure

The 1996 Lender Liability Amendments provide that a lender may maintain business operations, wind down operations, take measures to preserve, protect, and preserve the vessel or facility for sale or disposition, and even undertake response actions under section 107(d)(l) of CERCLA or under the direction of an On-Scene Coordinator (OSC) so long as the lender seeks to sell or re-lease (in the case of a sale/leaseback transaction) and complies with the foreclosure requirements set forth above.[55]

Lenders have encountered their greatest risk of liability when in post-foreclosure activities. Financial institutions should exercise extreme caution when conducting auctions and should consult with environmental counsel prior to conducting any auction at a manufacturing facility.

Along with the *Fleet Financial* case,[56] there are a number of unreported situations where lenders have been issued administrative orders by governmental agencies and have had to pay to perform a cleanup because of actions they took following foreclosure. These situations have typically taken place when a borrower has gone out of business and the bank takes control of the facility in order to sell off the inventory, fixtures, machinery, and equipment of the borrower subject to the bank's lien. The bank typically does not take title to the property in these circumstances because of fear that it will lose its exemption, but instead hires an auction company to conduct the sale of 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. To avoid any suggestion that the bank or the auction company had any control over hazardous wastes, the auction company 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 then left in the abandoned facility. At some point, government authorities find out that there are abandoned drums at the facility and

52. *Id.*

53. 57 Fed. Reg. 18354 (April 29, 1992).

54. *Id.*

55. The CERCLA Lender Liability Rule had required lenders to take actions consistent with the NCP, such as removing abandoned drums as ta facility where they have foreclosed upon, in order to preserve their immunity. 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. However, the Lender Liability Amendments did not expressly address this issue of post-foreclosure NCP compliance.

56. Foote v. Fleet Financial Corp., 2004 R.I. Super. LEXIS 117 (R.I. Sup. Ct. June 25, 2004), discussed *infra* at Pt.X.B.2.

order the lender to pay for the removal of the materials.

Lenders have often argued that the drums containing the wastes were not part of its collateral, that they have simply relinquished possession of unsold inventory back to their borrowers, or that they never exercised control over the drums because neither the lender 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. The EPA has consistently taken the position that such action constitutes an abandonment of hazardous wastes when the borrower is insolvent, thus creating generator liability for the lender.

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 lender would not be considered the generator of the waste. However, if such a representative is not available, the lender or one of its agents may have to execute the waste manifests. Since the lender would be considered a generator of the waste under these circumstances, the lender should select a reputable disposal or treatment facility.

As a result, the lender 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 the lender to retain an environmental consultant or environmental attorney to inspect the facility prior to taking control, in order to evaluate any possible environmental liabilities that may be associated with the auction. The lender can 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. 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 should take immediate steps to contain and clean up the spill and document those actions. In addition, the lender should have its counsel review both the lease and the state UST registrations to determine who is responsible for USTs that may be present on the property. 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 landlord believes that the USTs enhance the marketability of the site, the lender may be in a good position to negotiate a satisfactory resolution of 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 the hiring of 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 tot 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 held responsible for remediating environmental problems at the site. To minimize this possibility, the 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.

## III. The 1999 NationsBank Settlement

An example of the exposure that a bank may incur during workouts and foreclosure was the August 1999 EPA enforcement action involving NationsBank (the Bank) where the Bank agreed to pay EPA $300,000 to settle a cost recovery action that had been filed in connection with actions that the bank had taken during the liquidation of a borrower's assets. In the spring of 1989, the Bank extended a $4.75 million loan facility to Clearwater Finishing Inc. (The Company), secured by a mortgage on the property and liens on the personal property of the Company. Within a year, the Company was in a workout and the Bank held weekly meetings with the Company while also providing guidance to help the Company maximize its collections, shipping of goods, and collection of accounts.

These efforts proved fruitless and in the summer of 1990, the Company filed a petition for a Chapter 11 bankruptcy reorganization. When the plant closed for the July 4 holiday, the Bank refused to release funds from the revolving account to pay the employee wages. Unable to pay its employees and facing bomb threats from the angry workers, the Company and the Bank reached an agreement whereby the bank would pay half of the workers' salaries if the Company sought financing from another bank or allowed the Bank to liquidate its collateral located at the facility. The Company then hired a management firm to wind up its operations. The management firm hired a skeleton staff to complete operations, run the utilities, and secure the facility. The Bank agreed to pay the salaries of these employees out of the proceeds of account collections and liquidation of the collateral. The management firm made weekly reports to the Bank. After operations were permanently discontinued, a small staff of workers was retained to maintain the utilities and security to protect the collateral remaining on the property. The Bank continued to pay these workers' salaries, approved the collection and settlement of all accounts, authorized transfer of any materials, and received daily reports.

In December 1990, the bankruptcy court approved the Bank's motion for relief from the automatic stay for the purpose of liquidating the remaining assets, including "perishable" chemicals that were to be sold "as soon as possible." The Bank then hired a liquidation company to conduct the sale of the collateral. But by the spring of 1991, only twenty-eight percent of the value of the assets had been

sold. The President of the Company then made arrangements to sell the remaining chemicals to third parties. After the President and employees had loaded the chemicals onto a truck, the Bank refused to authorize the sale and insisted that the chemicals be placed back into the facility.

In the fall of 1991, the liquidation company advised the Bank that the remaining chemicals and dyes no longer had any value. The Bank informed the President of the Company that it would no longer provide heat, maintenance, or security for the facility. The chemicals remained at the property during the next two years. During the winter, the chemicals froze which caused some drums to burst. Other drums gradually deteriorated and released their contents within the facility. In 1992 the President sued the Bank for allowing the collateral to waste. The parties reached a settlement in 1993 in which the Bank agreed to complete liquidation of the assets in exchange for releasing the President from personal liability under his guarantee.

Subsequently, during the process of removing equipment from the facility, the liquidation company caused asbestos and chemicals to be released. In addition, the liquidation company created holes in the plant building that exposed many drums to inclement weather and caused further releases of hazardous wastes. The EPA then conducted an emergency response action and incurred the expense of $1.2 million to remove 2,700 drums containing spent dyes and other chemicals, twenty-seven aboveground storage tanks holding acids, solvents and caustics, an underground storage tank, smaller containers, and asbestos. The EPA then brought a cost recovery action against the Bank alleging that it was an operator of the facility. The Bank claimed that it fell within the secured creditor's exemption, but the EPA claimed the Bank was not eligible for the exemption because the Bank had allowed perishable chemicals to become hazardous wastes and therefore had not acted in a commercially reasonable manner. The EPA relied on UCC Article 2 case law to determine what actions were to be deemed "commercially reasonable" as opposed to "wasting" of the collateral.

This case once again illustrates the dangers that banks face when they try to repossess and sell collateral after a borrower has defaulted on a loan. Lenders also need to exercise extreme caution and perform detailed site inspections when foreclosing on assets of a defaulted borrower even when the lender does not take title to a property, because the mere act of possessing or exercising control over inventory or other collateral at a borrower's facility can expose the lender to possible liability as an operator.

## IV. 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 filled this void by adding a new subsection to section 107 of CERCLA, clarifying the scope and standard of liability for fiduciaries. 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 the 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, 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.

Section 107(n) does not apply to persons who are both fiduciaries and beneficiaries of the same fiduciary estate who receive benefits that exceed the customary or reasonable fiduciary compensation and incidental benefits. In addition, it odes not apply to the assets of the estate or trust, nor to a non-employee agent or independent contractor of the fiduciary.

The new subsection 107(n) 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;

- 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; or
- 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. 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 be expose the fiduciary to liability and the failure to take such action might amount to negligence that could expose the fiduciary to personal liability.

## V. 1999 CERCLA Contribution Action Against Fiduciary Bank

Under the Lender Liability Amendments, the limitation on the liability of a fiduciary 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 Court of Appeals for the Eleventh Circuit reversed a district court ruling in *Canadyne-Georgia Corp. v. NationsBank, N.A.*,[57] and allowed a former site owner to proceed with a contribution action against a bank that served as trustee for a trust that held a general partnership interest in a limited partnership owning the site.

In *Canadyne-Georgia*, a pesticide manufacturer had been owned by a general partnership. More than fifty percent of the limited partnership interest 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. Afer 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 bank argued that the Lender Liability Amendments protected fiduciaries from personal liability. The plaintiff responded that there was an exception when fiduciaries act in another capacity and directly or indirectly benefit from that capacity. The district court dismissed the plaintiff's complaint on the grounds that the bank was not a liable person under either CERCLA or 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. Although the bank technically held the general partnership in trust, it held legal title to the general partnership interest under Georgia law. At the time the bank held ownership of the general partnership, Georgia law provided that individual partners and not the partnership held title to real property. Since the bank had owned an interest in the general partnership that owned the site, 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, concluding that it would preclude only an action against a bank that held title solely by virtue of its status as a trustee. Since the complaint alleged that the bank as owner had negligently caused the release of hazardous substances, the court found that the complaint satisfied the very low threshold that is required for surviving a motion to dismiss and allowed the action to go forward. In so holding, the court made it clear that it was not holding 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 matter was remanded to the district court to determine if the releases that took place at the facility could be attributed to the bank's affirmative negligence.[58]

This case shows how easy it is for a plaintiff to keep a lender in a CERCLA case. While the bank ultimately prevailed in this case, it was forced to incur considerable litigation costs to demonstrate that it was 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 a state superfund claim even if that superfund law has a different (and more lenient) test for determining fiduciary liability. This suggests that 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.

57. 183 F.3d 1269 (11th Cir. 1999).

58. The district court subsequently determined that the bank had not been negligent, 174 F.Supp. 2d 1360 (M.D.Ga. 2001).

## VI. Third Party Actions

### A. Introduction

The CERCLA Lender Liability Rule did not extend protection for secured creditors to protect against actions filed by third parties. Since private parties bring most lender liability cases, this was a major concern to the lending community. By amending the definitions of owner or operator and the liability provisions of CERCLA, the Lender Liability Amendments 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.

## VII. Lender Liability Where Banks Hold Equity Interest in Borrower

The CERCLA and RCRA secured creditor exemptions apply when a lender holds indicia of ownership "primarily to protect a security interest." What happens, though, when a lender acquires shares in its borrower, or obtains high interest subordinated notes or similar debt instruments as part of the financing arrangement? Would the lender no longer be deemed to be primarily protecting its security interest and therefore lose its safe harbor by virtue of holding stock or high-risk debt?

Unlike the definition of "participation in management," there are no objective criteria for determining when a secured creditor holds "indicia of ownership primarily to protect its security interest." The EPA made it clear it its CERCLA Lender Liability Rule that this term was to be interpreted on a case-by-basis. With no definition in the current version of CERCLA, one must turn to the case law to see how courts have interpreted the meaning of this phrase. Courts have adopted the EPA's approach and generally will examine the facts of a particular transaction to determine the reason why the lender held indicia of ownership.[59] A bank seeking to take advantage of the secured creditor exemption will have the burden of proof to initially establish that it was entitled to the exemption.[60]

The vast majority of cases interpreting the phrase "primarily to protect the security interest" involve situations where the lender foreclosed on property and held title for a period of time.[61] These cases focus on why the lender held title to the property or whether the lender complied with the foreclosure guidelines set forth in the Lender Liability Rule or the 1996 CERCLA Amendments.

There is also a line of cases holding that when a lender has title to property in a sale- leaseback transaction, the lender has indicia of ownership primarily to protect its security interest. These courts have indicated that the exemption will protect a lender if its primary purpose was to protect a security interest and not to profit from an investment opportunity presented by prolonged ownership of property.[62] However, the mere fact that a lender might receive secondary benefits from its ownership of the property such as tax benefits from the depreciation of the property will not void its exemption.[63] Thus, these cases are not particularly helpful for evaluating if a lender can lose its exemption for its secured loans because of its equity stake in its borrower.

### A. The *Stearns & Foster* Case

One case that sheds some light on this issue is *Stearns & Foster Bedding Company v. Franklin Holding Company et al.*[64] In this case defendants, Franklin, M & T Capital Corporation (M & T) and Rand Capital Corporation (Rand), purchased promissory notes issued to finance the acquisition of a fire extinguisher manufacturer, Stop Fire-DE in 1973.[65] In exchange for money, each lender received a security interest in equipment, certain stock warrants, and one seat on the seven member board of directors (the Board). Franklin attended Board meetings at the plant and also hosted Board meetings. The 1973 agreement also appointed Franklin as agent for the other note holders. In December 1975, the Board approved a bankruptcy filing. In January 1976, Franklin and M & T exercised their warrants and became the sole shareholders of the company. They reconstituted the Board so that it was comprised of representatives of the three investors and the President of the Stop Fire-DE. The Board then fired all of the officers except for the President and hired new executive officers. Franklin admitted that it participated in the interviewing and hiring of a new Comptroller. In addition, after the President was fired in March 1977, Franklin's Executive Vice President served as President of the new company for seven months. Also in 1977, Rand exercised its warrants. Franklin and M & T continued to infuse fresh capital into the company until it was adjudicated bankrupt by a consent decree under the old Bankruptcy Act in April 1976. Franklin then purchased the physical assets of the debtor on behalf of itself and M & T, created a new entity and transferred the assets to the new entity, Stop Fire-NJ. IN 1979, the plaintiff acquired title to the manufacturing facility located in South Brunswick, New Jersey. In 1989, the plaintiff was forced to comply with RCRA and filed a cost recovery action against the former owners of the property and the lenders/shareholders. The plaintiff argued that Franklin and the

59. U.S. v. Lamb, Kemp Industries v. Safety Light Corp., 857 F.Supp. 373 (D.N.J. 1994).

60. Stearns & Foster Bedding Company v. Franklin Holding Corp. *et al*, 947 F.Supp. 790,802 (D.N.J. 1996).

61. *Compare* U.S. v. Maryland Bank & Trust Co., 632 F.Supp. 573 (D.Md. 1986)(bank holding title for four years was not entitled to the secured creditor exemption) *with* U.S. v. Mirabile, 15 Envtl.L.Rep. 20994.

62. Northeast Doran, Inc. v. Key Bank of Maine, 15 F.3d 1 (1st Cir. 1994); U.S. v. McLamb, 5 F.3d 69 (4th Cir. 1993).

63. *See In re* Bergsoe Metals Corp, 910 F.2d 668 (9th Cir. 1990). This view was also endorsed by the legislative history. *See* H.R. Rep No.1016, 96th Cong.2d Sess., P.L. 96-510, *reprinted in* 1980 U.S. CODE CONG & ADMIN. NEWS 6119,6181.

64. 947 F.Supp. 790 (D.N.J. 1996).

65. Franklin and M & T each provided the company with $350,000 while Rand provided $150,000.

other lenders/investors should be considered operators of the facility.

Much of the court's decision in *Stearns & Foster* focused on whether the three lenders could be deemed to have exercised actual control over the company. However, the court's opinion also contains some useful language regarding permissible motivations of lenders that would not cause them to lose their exemption. In concluding that the plaintiff had not established that Franklin had exercised actual control over the company sufficient to make it an operator of the facility, the court said that Franklin was seeking only to maximize its return on its investment and not to operate a fire extinguisher company. For M & T, the court said that "the mere fact that a lender takes an equity position in its debtor does not necessarily place the lender beyond the pale of...[the secured creditor's exemption]"[66] However, the court went on to say that a decision to convert debt to equity "...signals an abandonment of an effort to protect a security interest. The lender's role then arguably becomes that of an investor."[67] The court also said that the fact that a lender's primary motive was no longer to protect its security interest merely meant that the lender could no longer avail itself of the secured creditor's exemption and that it's liability would have to then be judged under the traditional CERCLA owner or operator analysis.[68] Though this case was decided after the passage of the 1996 Lender Liability Amendments, that law did not play a role in the decision because the issue before the court was whether the defendants could be held liable as operators of the facility.[69]

The *Stearns & Foster* case suggests that a lender should not lose its secured creditor exemption simply because of its minority stake in a borrower or because it received dividends in connection with its stock ownership. Instead, the critical factor would be whether the lender was taking liens on the assets primarily to protect its loans. Even if the primary purpose of the financing facility is to protect its security interest, it would seem that the lender should not lose its secured creditor exemption simply because as a secondary benefit of the transaction it receives dividends or generates income from its stock ownership. However, if the primary purpose of the financing facility is to facilitate the purchase of the stock, then the lender likely would not be eligible for the secured creditor exemption.

### B. The *DuFrayne* Case

Another case addressing the impact of a lender's profit motive on the secured creditor exemption is *DuFrayne v. FTB Mortgage Services, Inc.*[70] In this case the plaintiffs purchased a home in 1989 for $140,000, financed by a $108,000 mortgage. Two years later, they discovered that their home along with approximately forty others had been constructed on radium ore tailings from a local mill that had been used as fill material. The EPA placed the area on the federal superfund list and temporarily relocated residents while it installed air exchangers. After completing its investigation, the EPA issued a cleanup remedy that provided the residents with an option of either relocating to a new home off-site or staying on-site in either a new home or a reconstructed existing home. The plaintiffs elected to have a new home constructed. Meanwhile, the plaintiffs had stopped making their mortgage payments. Instead of foreclosing on the contaminated property, their lender elected to recover the amount due on the mortgage note and received a judgment of approximately $126,000. Shortly after the entry of the judgment, the plaintiffs filed a Chapter 11 bankruptcy petition. The lender then sold the note to the defendant. The plaintiffs's initial reorganization plan was denied confirmation because they had failed to provide the defendant with adequate notice. Their amended plan requested that the defendant's claim be reduced to zero because the defendant was liable to them as a CERCLA owner. The defendant filed a motion to dismiss, arguing that as a secured lender it was not liable under CERCLA.

The crux of the plaintiff's claim was that the primary motive of the defendant in holding indicia of ownership was not to protect its security interest but to profit from the cleanup performed by EPA. They argued that the defendant acquired the note knowing that the EPA planned to build a new residence, and that the defendant intended to capitalize on the investment opportunity presented by the long-term ownership of that interest. The *DuFrayne* court recognized that an investment motive is present in all mortgage financing transactions. However, the court wrote that the defendant's investment interest was in the paper note and not the property. Noting that mortgages were routinely traded in the secondary mortgage market, the court said that the defendant had no greater interest in the property than the original mortgagee would have, had it not parted with the note. In addition, the court noted that the plaintiffs could not point to any cases where the secured creditor exemption was lost because the lender acquired its mortgage interest at a discount in the secondary market. Since the plaintiffs failed to allege any facts to support the claim that the defendant could be liable as a CERCLA owner, those counts in the adversary proceeding were dismissed.

Like the mortgage in the *DuFrayne* case, it is not unusual for lenders financing an acquisition contemplated in a proposed transaction to take small equity positions in their borrowers. Therefore, as long as the primary motive for the indica of ownership is to protect its security interest, the lender could argue that the fact it may derive a profit from its minority equity interest in its borrower should not cause it to forfeit the secured creditor exemption.

66. 947 F.Supp. at 807.

67. *Id.*

68. *Id.*

69. In a footnote, the court said the 1996 Lender Liability Amendments lent some support to the contentionsw of M & T and Rand, but was not critical to the court's analysis since the plaintiff had chosen to base its summary judgment motion on the alleged "operator" liability of those two entities. *Id.* at 802-03 n.6.

70. 194 B.R. 354 (Bankr.E.D.Pa. 1996).

None of the cases holding shareholders liable under CERCLA have imposed liability solely on the basis of stock ownership. If an investment fund or institutional investors loses its secured creditor exemption, its CERCLA liability would be based on whether it had a controlling interest in the company. Thus, investors with a minority interest in a corporation or with representation on a board proportionate to their shares should not incur liability if they do not engage in active management or otherwise exercise operational control over the corporation.

However, the CERCLA liability net is still quite wide. A 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.

### C. The *Duplan* Case

In *In Re Duplan Corp et al v. Esso Virgin Islands, Inc.*,[71] Duplan Corporation (Duplan) filed a petition for reorganization under the old Bankruptcy Act in 1976. Six years before the bankruptcy filing, Duplan had acquired Laga Industries, Ltd. (Laga), a textile manufacturer located in the U.S. 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. (Panex). The creditors of Duplan were given cash and share in Panex in partial satisfaction of their claims.

One of the creditors who received share in Duplan/Panex was Goldman, Sachs & Co. (Goldman). 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 plan of reorganization 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 other 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 of 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 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, the EPA discovered that property adjacent to the former Laga facility was contaminated with a variety of hazardous substances. In 1988, the 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 pre-empted 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 Third Circuit U.S. Court of Appeals reversed the injunction and instructed the district court to dismiss the CERCLA claims because they were time-barred 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 district 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 bankruptcy petition. Since CERCLA had been enacted afer the date that 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 then by the Second Circuit. The Second Circuit indicated that for a bankruptcy

71. 212 F.3d 144 (2nd Cir. 2000).

claim to be valid, the claimant must have a right of payment and that right must arise prior to the filing of the petition. 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 compromising 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 prior to 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 arouse 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 arouse at that time and before the issuance of the order confirming the plan of reorganization. The court did bar the RCRA 7002 actions because the EPA had satisfied the diligent prosecution requirement. On the common law claims, the second circuit found that the bankruptcy court had not determined when those claims arose. As a result, the court remanded the CERCLA and common law claims to the district court for further consideration.

To the extent that a shareholder/lender monitors compliance, has knowledge about environmental conditions at a subsidiary's plant, or merely provides environmental or general business advice to its borrower, it would not likely incur liability in a majority of jurisdictions in the absence of actual involvement in the operations of the plant. Furthermore, actions indicative of a prudent credi- tor or investor, such as monitoring a subsidiary's fiscal operations and consolidation of certain administrative functions, should also not expose a lender to liability so long as the actions do not cross the line into daily management of the business.

## VIII. 2002 Citigroup $7.2 Million Settlement[72]

A federal district court approved a settlement that resolves the liability of S.W. Shattuck Chemical Company (Shattuck) and its corporate affiliates Philbro Resources Corporation, Salomon Smith Barney Holdings, Inc., and Citigroup, Inc. for a former radium-processing plant located in Denver. Citigroup Inc. became involved in this site through its acquisition of Salomon Smith Barney Holdings, Inc. (SSBH), which had in turn had acquired Philbro Resources Corporation, a prior owner of Shattuck. SSBH had issued a corporate guaranty of Shattuck's obligations in June 2000 and a predecessor of SSBH had issued another corporate guaranty in 1993.

Under the terms of the consent decree, Shattuck agreed to pay $7.2 million for response costs and natural resources damages. In addition, Shattuck agreed to establish a trust and convey the 5.9-acre parcel to the trust. The trustee is obligated to sell the site, valued at more than $1 million, and deposit the net proceeds of the sale into a special account the EPA has established for the site. As part of the settlement, the EPA agreed that the guarantees were no longer in effect. The purchaser and trustee received a Covenant Not To Sue (CNTS) for liability arising out of the existing contamination provided the parties cooperate with the EPA and do not interfere with EPA response actions. The Shattuck's corporate affiliates also received a CNTS. Shattuck originally paid $26 million to entomb radioactive waste within a cement cap. After community groups became concerned about the adequacy of the cap, the EPA amended the Record of Decision (ROD) to demolish the cement monolith encasing the low level radioactive materials, dispose the stabilized soil, fly ash, and cement monolith debris, and to remove use restrictions imposed on the site as a result of the prior remedy.

72. United States and the State of Colorado v. The S.W. Shattuck Chemical Company, Inc., C1-2404 (D. Col. 2001); Al Knight, *The EPA Farce Rolls On*, Denv. Post, Jan. 16, 2002 at B11.

## IX. Liability of Lenders in Securitizations

### A. The *LaSalle Bank* Case—Introduction

Lenders can face liability in securitizations if they do not adequately investigate the environmental issues. This exposure was illustrated in *LaSalle Bank National Association v. Lehman Brothers Holdings, Inc.*[73] As usual, the facts are complex but warrant attention.

### B. The MLPA

In this case, Lehman Brothers Holdings (Lehman) entered into a Mortgage Loan Purchase Agreement (MLPA) with the First Union Commercial Mortgage Securities, Inc. (First Union) on November 1, 1997 for more than 200 commercial and multi-family mortgage loans. Pursuant to the MLPA, the mortgages were deposited by First Union into a trust fund with a face value of over $2.2 billion. Certificates were issued pursuant to a Pooling and Service Agreement (PSA),[74] and the mortgage loans were "securitized" on November 25, 1997. Various classes of investment certificates bearing different payment priorities and corresponding levels of risk were offered for sale pursuant to a Prospectus Supplement. The lowest-rated class, which bore the "first dollar loss" incurred by the trust, was known as the "B-piece." CRIIMI MAE, Inc. (CMI) purchased the entire B-piece for $170 million.

Prior to the execution of the MLPA and the PSA, CMI sent First Union and Lehman a Quote Letter setting forth the terms under which it would purchase the B-piece. Under the terms set forth in the

73. 237 F.Supp. 2d 618 (D.Md. 2002). *See also* related case: *In re* William Hurley et al, 285 B.R. 871 (Bankr.D.N.J. 2002).

74. Parties to the PSA were First Union, First Union National Bank, CRIIMI MAE Services Limited Partnership (CMSLP), LaSalle Bank, and ABN AMBRO Bank, N.V. (AMBRO Bank). Plaintiff LaSalle Bank serves as the Trustee of the trust in question. Under the PSA, plaintiff LaSalle Bank as Trustee was responsible for allocating cash flows generated by the loans. The mortgage loans were to be serviced and administered by First Union National Bank as the Master Servicer and CMSLP as the Special Servicer, with AMBRO Bank acting as the fiscal agent.

Quote Letter, Lehman was required to provide CMI with copies of its underwriting files so that CMI could "re-underwrite" the loans. CMI then had the right to demand that loans not approved by it would be excluded from the pool. After CMI competed re-underwriting the loans, it was required to transfer the loan documents it had received from Lehman to CMSLP. CMI exercised this option and rejected seven loans totaling over $40 million.

In the MLPA, Lehman made numerous representations and warranties regarding to each mortgage loan it sold pursuant to the MLPA. According to section 3(b) of the MLPA, Lehman made these representations and warranties "for the benefit of the Purchaser and the Trustee for the benefit of the Certificate holders." Section 3(c) of the MLPA provided that if Lehman received notice of a breach of its representations and warranties, it had the duty to cure the breach or repurchase the affected mortgage loan.

### C. The FEL Facility

One of the mortgages in the trust was a $9 million mortgage loan that Lehman sold to First Union. This loan was secured by industrial property located in Farmingdale, New Jersey (the FEL Facility). The property was owned by Dr. William D. Hurley (Hurley) and leased to his company, known as Frequency Engineering Laboratories (FEL). The FEL Facility has a long history of environmental problems. FEL was a government contractor that manufactured military communications equipment and weapons systems. The manufacturing process involved the use of heavy metals and volatile organic solvents. After Phase I environmental site assessments in 1994 and 1996 recommended a Phase II investigation to determine the extent of any potential soil or groundwater contami-nation, a limited soil and groundwater investigation was performed in August 1996. The Phase II investigation revealed that the groundwater had been impacted with volatile organic compounds (VOCs) and recommended further evaluation of the groundwater. Environmental counsel retained by Hurley agreed with the conclusions of the Phase II investigation and recommended that the results be reported to the New Jersey Department of Environmental Protection (NJDEP). Ten months later, Hurley's environmental counsel retained another consultant to perform additional sampling for metals but not VOCs (the Phase III investigation). The consultant then issued a report recommending no further action and attached the results of the 1996 Phase II report.

At this same time, Hurley was seeking refinancing of the FEL Facility. He transferred the FEL Facility to an entity owned by him and known as WDH Howell, LLC (Howell), and submitted a loan application to Holliday Fenogio, L.P., a Florida mortgage finance entity (Holliday). Holliday had a contract with Lehman whereby Holliday would locate and originate commercial mortgage loans and Lehman would agree to purchase these loans form Holliday for inclusion in a mortgage pool. In October 1997, Holliday extended a mortgage loan to Howell in the amount of $9 million that was secured by the FEL Facility (the FEL Facility Mortgage Loan).

### D. The Environmental Warranties

In the FEL Facility Mortgage Loan documents, Howell represented that it "had not failed to disclose any material fact that could cause any representation or warranty made [in the mortgage] to be materially misleading." Howell and Hurley also made broad environmental representations and warranties in the mortgage and the environmental indemnity.[75] Lehman then purchased the mortgage loan and resold it to First Union pursuant to the MLPA. Pursuant to the terms of the FEL Facility Mortgage Loan, Hurley, as indemnitor, and Howell, represented that the property was in full compliance with all applicable laws and that all representations and warranties made by each indemnitor, in any loan document were true and correct. In addition, Hurley and Howell also executed an Environmental Indemnity Agreement where they made numerous representations and covenants concerning the environmental condition of the FEL Facility. A breach of any one of these representations and covenants constituted a default under the terms of the FEL Facility Mortgage Loan.

Two days after the mortgage loan closed with Lehman, Hurley entered into a voluntary cleanup agreement with the NJDEP. In June 1998, the NJDEP advised Hurley that the Phase II investigation was deficient because it had not sampled for VOCs. Further sampling in April, September, and October 1999, and in May 2001, revealed VOCs far exceeding the NJDEP groundwater quality standards.

In April 2000, the FEL Facility Mortgage Loan was transferred to CMSLP for special servicing because Howell had defaulted in making mortgage payments. Afer CMSLP began servicing the loan, it had another Phase I assessment performed on the FEL Facility, which revealed various environmental contamination. On August 3, 2000, CMSLP instituted a foreclosure action against the FEL Facility property in a state court in New Jersey. The action was stayed when Howell filed a Chapter 11 bankruptcy petition. On December 11, 2000, CMSLP notified LaSalle Bank and others that the warranties and representations set forth in the MLPA had been breached because the FEL Facility property was environmentally contaminated at the time of the loan. CMSLP requested that the Master Servicer demand that Lehman cure or repurchase the loan pursuant to section 2.03(a) of the PSA. A copy of that letter was sent to Lehman. On January 25, 2001, Lehman denied the existence of any breach.

75. The representations and warranties made by Howell and Hurley in the Environmental Indemnity Agreement included, inter alia, that there are no past or present releases of hazardous substances on the property or past or present non-compliance with environmental laws that were not disclosed in the environmental reports given to the lender Holliday. Howell and Hurley further represented that they had provided to the lender Holliday any and all information relating to conditions in, on, under or from the mortgaged property as known to them.

### E. Arguments of the Parties

On August 1, 2001, plaintiff LaSalle Bank filed a lawsuit alleging that Lehman had breached certain representations and warranties and certain remediation provisions of the MLPA. It alleged that, notwithstanding the representations and warranties of Lehman, the FEL Facility was environmentally contaminated at the time of the sale, and that the borrower was in default under its mortgage at the time that the MLPA and the PSA were executed.[76] The plaintiff argued that Howell and Hurley made numerous misrepresentations about the environmental condition of the FEL Facility. However, Lehman countered that it represented in Warranty "XX" that it had no knowledge of material and adverse environmental conditions other than those disclosed in the referenced environmental reports. Lehman further argued plaintiff's interpretation of Warranty "XIV" would require that Lehman be responsible for warranties of adverse environmental conditions that were not disclosed in the reports.

### F. The Court's Conclusions

The court concluded that Howell and Hurley were so anxious to secure the loan from Holliday that they attempted to conceal existing environmental contamination by failing to disclose in the loan documents numerous material facts concerning the environmental condition of the FEL Facility. Based on the evidence of record, the court found as a matter of law that the FEL Facility Mortgage was in default on November 25, 1997.

Lehman argued that CMI did its own "re-underwriting" and that as a result of its due diligence CMI should be the party to bear the loss. However, the court said that CMI was merely the purchaser of the so-called "B-piece," and the due diligence conducted by it was done solely for its own account as a certificate holder. The court concluded that CMI had no duty to undertake any due diligence on behalf of the trust or any of the other certificate holders. LaSalle Bank, as the Trustee, had the right to rely in the event of default on Lehman's representations and warranties, including those relating to the origination and underwriting practices employed by Holliday and Lehman with respect to the FEL Facility Mortgage Loan. The court said that Lehman and not LaSalle Bank assumed the risk that the mortgaged property was environmentally contaminated when the $9 million was loaned to Hurley.

The court went on to say that MLPA did not exculpate Lehman from liability for the default of Howell and Hurley merely because the facts were not uncovered by Lehman's environmental due diligence. Because of the multiple misrepresentations by Howell and Hurley, the court found that Lehman would have a viable claim against Holliday, Howell, and Hurley.[77] As a result, the court held it would not be unfair to hold Lehman accountable for unknown environmental conditions.

Indeed, the court found that the evidence established as a matter of law that the origination and underwriting practices of both Holliday and Lehman were not prudent and did not meet customary industry standards. As a result, the court found that Lehman had breached both Warranty XXII and Warranty XLVI of the MLPA,[78] and that the defaults were material. In so holding, the court pointed to the following evidence:

- Lehman and Holliday did not follow the Phase I recommendation even though the Prospectus Supplement informed investors that Phase I recommendations were being followed.
- Lehman and Holliday did not obtain a new Phase I assessment report before the closing, as required by Lehman's guidelines and as represented in the Prospectus Supplement.
- Lehman obtained an updated environmental assessment only after the loan had been closed, and
- Holliday suggested to the consultant that it come to the same conclusions as the prior report.

The court also found that LaSalle Bank, as Trustee, was not involved in any way in the origination of the loan and had the right under the various agreements to look to Lehman and its representations and warranties to protect itself from loss resulting from the default.[79]

Lehman had claimed that LaSalle Bank was placed on notice of the need to inquire about a potential breach of warranty because Warranty XX referenced reports that disclosed that the FEL Facility was contaminated. However, the court concluded that the reports referenced in Warranty XX would not have placed LaSalle Bank on such notice or notice that Lehman had breached its warranties, because the Phase III investigation concluded that no further action was required. The court said that a person of ordinary prudence reviewing this report would have concluded that if any of the contaminants found at the FEL Facility

76. Warranty XIV provided in pertinent part: "Other than payments due but not yet thirty days or more delinquent, (A) there is no material default, breach, violation or event of acceleration, and there is no other material default, breach, violation or event of acceleration, existing under the related Mortgage Note or each related Mortgage...."

77. Six separate paragraphs of this August 19 letter from Hurley's environmental counsel discussing the some of the environmental conditions of the property were eliminated in the August 20 version of that letter that was sent by Hurley to Holliday in support of Howell's application for the $9 million mortgage loan.

78. In Warranty XXII, Lehman represented that the mortgagor of each property had covenanted to maintain the related property in compliance with all applicable laws and that the originator had performed "the type of due diligence in connection with the origination of such Mortgage Loan customarily performed by prudent institutional commercial and multifamily mortgage lenders." In Warranty XLVI, Lehman represented that, "the origination, servicing and collection practices used by [Lehman] or any prior holder of the Mortgage Note have been in all respects legal, proper and prudent and have met customary industry standards."

79. Lehman contend argued that the PSA granted CMSLP the exclusive right to bring suit when a loan is referred to it for special servicing and that LaSalle Bank was not authorized to prosecute claims relating to loans which have been referred for special servicing to CMSLP. However, the court ruled that the provision allowing CMSLP the right to institute a suit in its capacity as Special Servicer did not negate the rights of LaSalle Bank.

were of concern, the report would have recommended further testing or a remediation plan but would not have recommended that no further action be taken.

The court also found significant that the Phase III investigation only dealt with a small portion of the FEL Facility and did not address other material matters (*e.g.*, that there was environmental contamination at an adjacent site) and that the Phase I assessment had recommended that a full site investigation be conducted.

Because the court found that Lehman had breached warranties and representations contained in the MLPA, it was required pursuant to section 3(c) of that Agreement to repurchase the affected mortgage loan from LaSalle Bank at a price equal to the purchase price. If Lehman could not repurchase the FEL Facility mortgage loan because of the pending bankruptcy proceedings, the court ruled that LaSalle Bank would be entitled to recover $11,497,861.86 in damages as alternative relief.[80]

## X. State Environmental and Common Law Actions Against Lenders

### A. State Mini-Superfund Laws

#### 1. Introduction

There are approximately two-dozen states that have enacted some form of secured creditor exemption to their state counterparts to CERCLA (often called mini-Superfund Laws). Since the Lender Liability Amendments do not address these state mini-Superfund Laws, can still face liability under these state laws even if they comply with CERCLA.

The state secured creditor exemptions may not necessarily track the CERCLA or RCRA secured creditor exemptions. Thus, lenders should become familiar with the requirements of any state lender liability laws or requirements before foreclosing on property located in those states or engaging in any workout activities in those states.

#### 2. The *Corestates* Case

For example, in *Corestates/New Jersey National Bank v. DEP*,[81] a bank foreclosed on property in New Brunswick. The bank performed a Phase I Environmental Site Assessment prior to foreclosure; erected fencing with razor wire; maintained motion sensors, fire monitoring, and sprinkling systems; installed floodlights; and hired private detectives to inspect the site several times a week. The bank complied with the New Jersey Industrial Site Recovery Act (ISRA) and obtained a "no further action" letter from the NJDEP. The bank also retained a property management company to actively market the property. The Phase I assessment had recommended that the bank dismantle or drain two transformers at the property but the bank declined to follow this advice because the heavy power transformers were critical to the marketing of the property. Vandals subsequently broke into the property and, during the process of removing copper wire form the transformer, caused a PCB-contaminated oil spill that contaminated the groundwater beneath the property and flowed to a stormwater where it eventually impacted a stream. The security measures and active marketing of the property by the bank clearly complied with the requirements of the CERCLA secured creditor exemption. Despite these actions, the administrative law judge found that the bank was negligent under state law because it had been aware of prior vandalism yet declined to drain the transformers as advised by its environmental consultant.

#### 3. Other Claims—The *Carrion* Case

The state lender liability laws usually only limit liability under the state superfund law and do not provide protection against other statutory or common claims. Thus, even if a lender qualifies for a state secured creditor exemption, it should evaluate the possibility of liability under other state statutory or common laws. For example, in *Carrion v. 605 Realty Associates*,[82] the federal District Court for the Southern District of New York refused to dismiss claims filed against the Federal Home Loan Mortgage Corporation (Freddie Mac) for damages sustained by an exposure to LBP. In this case, Freddie Mac purchased a building in New York City at a foreclosure auction and transferred title six months later to the co-defendant. During the time that Freddie Mac owned the building, the plaintiff and her two children moved in with the building superintendent. In February 1993, the plaintiff's children were found to have elevated lead levels in their blood and the New York City Department of Health issued an Order to Abate Nuisance in March 1993. Freddie Mac transferred title one week later to the co-defendant. The plaintiffs commenced their action against the current owner in 2002 who, in turn, filed cross-claims against Freddie Mac.

For a landlord to be liable under the New York City Lead Abatement Law, the plaintiff must establish that the landlord had actual or constructive notice of the lead hazard and that children six years or younger resided at the premises. Following discovery, Freddie Mac moved for summary judgment, arguing it was not liable because it was not aware that young children lived in the apartment. However, the court ruled that the superintendent's knowledge that young children were residing in the building could be imputed to Freddie Mac. As a result, the court found that a reasonable jury could conclude that Freddie Mac had constructive

80. The damages consisted of the principal amount of the loan ($8,285,851.57), plus ordinary interest ($1,884,400.59), plus default interest ($899,475.22), plus servicing advances ($798,124.48), and minus sums already collected by LaSalle Bank during the bankruptcy proceeding ($370,000.00).

81. OAL DKT No. ESF 611-97 (Nov. 26, 1997).

82. 02 Civ. 2166 (S.D.N.Y. July 13, 2004).

knowledge of the LBP hazard during the time it held title to the building.

#### 4. USTs

In *Edwards v. First National Bank of North East*,[83] the owner of a gasoline station/mini-market defaulted on its mortgage and the defendant bank foreclosed on the property. After the bank acquired title to the site, the bank performed a tightness test on the USTs. While the USTs passed the test, petroleum contamination was detected when the USTs were removed. Presumably, the contamination was from older tanks that had been replaced. 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/borrowers 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 (the Act). The trial court ruled that the state lender liability statute which was patterned after the equivalent CERCLA provision, insulated the bank from any environmental liability. However, a state appellate court reversed the decision. The court said that banks which complied with the requirements of the state lender liability law were only immune from suits for the cleanup of contamination. The court held that state lender liability laws (including the Act) did not pre-empt common law causes of action, and remanded the case back to the trial court for a hearing on the merits of the common law claims.

The importance of performing due diligence and considering state environmental laws prior to foreclosure is illustrated in two additional cases. In *Hawkeye Land Co. v. Laurens State Bank*,[84] Leo Koenig operated a bulk petroleum storage facility under a lease with the plaintiff and had also granted a security interest in the leasehold improvements on the site. When Koenig defaulted on his lease, the plaintiff/property owner terminated the lease and ordered the Koenig to remove the storage tanks and improvements on the property as required by the lease. By this time, Koenig had also defaulted on his loan obligation with Laurens State Bank (Laurens) and when Laurens threatened to foreclose on the leasehold improvements, Koenig agreed to convey all of his interest in the leasehold improvements to the bank. Koenig then notified the plaintiff that the bank had succeeded to his interest in the storage tanks and improvements and that he was no longer responsible for removing these structures.

When the plaintiff/property owner was unable to sell the property because of the presence of the USTs, it received an offer for the USTs from a salvage company and requested that Lauren relinquish its claim to the structures. The bank refused and also declined the plaintiff's request to remove the tanks. When a buyer for the property was found, Lauren insisted that $1,500 of the $3,500 sale price be paid to the bank in exchange for release of its interest in the improvements. When the sale fell through, the plaintiff filed suit against Lauren, seeking injunctive relief ordering the bank to remove the storage tanks. Lauren argued that the storage tanks were fixtures that had become part of the real estate and were therefore the responsibility of the plaintiff. After a state appellate court had reversed a ruling in favor of Lauren, the Iowa Supreme Court ruled that Lauren had exercised sufficient control over the storage to be deemed the owner of the improvements and that their continued unwanted presence amounted to a trespass. Therefore, the court ordered Lauren to remove the storage tanks.

Likewise, in *Nischke v. Farmers and Merchants Bank*[85] the defendant bank extended a loan to the plaintiff, who operated a gasoline station. The loan was secured by certain assets, including the plaintiff's equipment. When the plaintiff defaulted on the loan, the defendant bank accepted a transfer of the assets in lieu of foreclosure. Following the transfer, the bank sent the plaintiff's husband a letter confirming that it had taken possession of their assets and offered to sell back the gasoline pump and UST. The court found that the bank had exercised sufficient dominion and control over the USTs and allowed the plaintiff to recover its remedial costs even if they exceeded the value of the property.

### B. Liability of Lenders for Inadequate Disclosure of Environmental Conditions

#### 1. Introduction

A number of states also have disclosure statutes that require disclosure of environmental conditions. Lender liability statutes in those states generally do not provide protection for common law claims for failing 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 the loan due diligence.

#### 2. The *Fleet Financial* Case

In one example, a Rhode island Superior Court jury ruled that Fleet Bank was liable for $5.14 million in damages for failing to inform the purchasers of a general store that the property's drinking water was contaminated. With accrued interest, the total award could be $10.3

83. 712 A.2d 33, 122 Md. App. 96 (Ct. Sp. App. June 24, 1998).
84. 480 N.W.2d 854 (Iowa 1992).
85. 522 N.W.2d 542 (Wis. Ct. App. 1994).

million. In *Foote v. Fleet Financial Group*,[86] Fleet Bank-NH (Fleet) foreclosed on the old Spofford General Store in 1991 and then conveyed the property to a subsidiary, Industrial Investment Corporation-NH (IIC) that was established to manage a commercial estate for Fleet. After a discharge of heating oil occurred in 1995, the New Hampshire Department of Environmental Services (NHDES) requested that Fleet perform an initial site characterization report. An environmental consultant retained by the Fleet Corporate Environmental Risk Management office found contaminants not commonly associated with fuel oil above the state groundwater quality standards and elevated levels of dichlorethane in the drinking water well. The consultant recommended additional monitoring, removal of fuel detected in the wells, and an investigation to determine if the contaminants were originating from an upgradient source.

Approximately forty-one days after receiving the environmental report, Fleet advertised the property for public auction with a minimum bid of $30,000. According to the plaintiffs, Fleet originally sought $120,000 for the property but after receiving the report, the bank vice president managing the property recommended accepting any offer above the minimum bid. The plaintiffs also claim that they asked the Fleet property manager about rumors of contamination at the auction and he responded that the property was being sold with a "clean bill of health." The purchasers acquired the property for $45,000 and lived at the site while operating a general store. The sales agreement contained an acknowledgment that the seller never physically occupied the site and had no knowledge regarding the private water supply, sewage disposal system, or other conditions required by the New Hampshire residential property disclosure law.

Five days after the sale of the property to the plaintiff, NHDES advised Fleet that it should implement the recommendations contained in the environmental report and requested a budget. Fleet did not respond to the request of the NHDES and subsequently requested reimbursement from the state UST trust fund. The NHDES then advised Fleet that it would have to install a vent alarm system before it could be eligible for reimbursement. The plaintiffs said that Fleet never informed them about these communications with the NHDES, and that they only found about the contamination four years later from newspaper accounts discussing the contamination at the upgradient site. The jury found that Fleet had engaged in intentional fraud, and wanton, malicious, or oppressive conduct.

### 3. Failed Banks--The *Boston Foundation* Case

In *Boyle v. Boston Foundation, Inc.*,[87] a bank that failed to disclose to purchasers of contaminated property the existence of notice from a state agency ordering a cleanup at the site was not held liable for misrepresentation because of a doctrine unique to failed financial institutions taken over by the FDIC. The FDIC was acting as a receiver for the failed bank. The failure of the bank to disclose material information was held to constitute an "agreement" under the *D'Oench* doctrine and since this was an unwritten agreement, the plaintiffs could not prevail against the FDIC. It is likely that the plaintiff would have prevailed had the bank not been in the custody of the FDIC.

### 4. The Perils of Customer Service

Many banks maintain a list of approved environmental consultants that may be used by bank employees when deciding who to hire to perform environmental due diligence. When a prospective borrower is purchasing property and seeks to perform an environmental site assessment, the prospective borrower may ask the prospective lender to recommend a consultant. The dangers involved in recommending environmental consultants were illustrated in *Lippy v. Society National Bank*.[88]

In that case, the plaintiff planned to purchase property on which stood an abandoned gasoline station. The plaintiff was concerned about environmental issues but did not know either how to evaluate the environmental conditions of the property or that his partners did not want to get involved with such a site. However, the new business officer of the defendant bank told the plaintiff that the bank officer could "solve his problem" and recommended an environmental consultant. The consultant apparently had been used by the bank only to conduct asbestos surveys and was not familiar with gasoline stations.

Nevertheless, the consultant concluded that the site did not have any environmental problems or possible violations. After the deal was consummated, the plaintiff discovered that USTs were still buried at the site and extensive remediation was required. The plaintiff sought reimbursement from the defendant on the grounds that it negligently recommenced the consultant. The defendant bank claimed it was only providing business advice and owed no special duty to the plaintiff. The trial court handed down a directed verdict in favor of the bank but the appellate court reversed, holding that the bank owed a fiduciary duty to the plaintiff.

## C. Other Issues

### 1. The Importance of Pre-Foreclosure Diligence

In *Chase Lincoln Bank v. Kesseling-Dixon*,[89] a bank unsuccessfully sought to undo a judgment of foreclosure on property that turned out to be contaminated with hazardous substances. After

86. No. 99-6196 (May 6, 2004).

87. 788 F.Supp. 627 (D. Mass. 1992).

88. 623 N.E.2d 108 (Ohio Ct. App. 1993).

89. 554 N.Y.S.2d 379 (Sup. Ct. 1990).

obtaining a judgment as the basis for foreclosure and sale, the plaintiff bank did not immediately proceed to foreclosure. Instead, the bank conducted an environmental audit which revealed that the soil was contaminated with gasoline and its constituent elements. Arguing that the contamination was a material change in the circumstances under which the judgment had been granted, the bank moved to vacate the earlier judgement fifteen months after it was granted, and sought instead to recover the debt from the borrower's principals.

The court found that the bank should have been aware from the chain of title that the property had been previously used by Texaco Oil Company and that a site inspection would have put the bank on notice of the potential contamination. Since the bank had failed to examine the property prior to electing to pursue the foreclosure remedy and the borrower had not deceived the bank, the court refused to grant the relief sought by the bank. The obvious lesson from this case is that a lender should perform environmental due diligence prior to exercising any of its rights.

#### 2. Cooperation with the Debtor Not Required

*Gainer Bank v. Bongi Cartage, Inc.*[90] considered the extent to which a bank must cooperate with a borrower in cleaning up contaminated property. The defendant had defaulted on its loan and the plaintiff bank sought to foreclose on the property. Prior to the foreclosure proceeding, the defendant had negotiated a deal with a private environmental organization which agreed to purchase the property (which contained wetlands) for a nominal fee in exchange for agreeing to remediate contamination on the site. To allow this deal to proceed, the bank had to relinquish its lien. The court ruled that the plaintiff was not required to release its lien even if this would prevent a cleanup because the defendant/borrower was in default of its loan.

#### 3. Gaining Access to the Site

Gaining access to a site to perform an environmental audit can be a problem at times, especially when a borrower has defaulted and relations between the lender and its borrower are strained. In *Resolution Trust Corp. v. Polmar Realty, Inc.*,[91] a federal district court ruled that because of the importance of environmental due diligence, a lender could obtain injunctive relief ordering a borrower to provide access to the site to enable the lender to perform a Phase II environmental investigation. While the court found that the lender would suffer irreparable harm if it was not allowed to investigate the site, the key factor was that the mortgage provided the lender with a right of entry and immediate possession of the property. The borrower argued that the right of entry was a standard provision that was not meant to allow a lender to perform the kind of broad-ranging inspection sought by the lender and that the testing would be extremely disruptive to its business. The court found that the purpose of the mortgage provision was to give the lender physical control of the property as needed to protect its loan, and that a Phase II fell within that broad authority. However, the court imposed conditions on the lender to make sure that the environmental investigation limited disruption of the borrower's business as much as possible, that the test be done carefully and in accordance with law, and that the lender provide insurance against damage resulting form the testing. Based on the holding in this case, lenders would be well-advised to review their loan documents to assure that there are adequate provisions to provide them with a right of entry. It may also be advisable to specifically allow for the performance of environmental audits, and to deal with the issues addressed by the courts.

#### 4. Assignee's Rights

In *Norwest Financial Leasing v. Morgan Whitney*[92] the plaintiff who was the assignee of a promissory note that was secured by a mortgage sought to rescind the sale of property that was found to be contaminated after the sale. The plaintiff also sought to recover economic damages against the vendor for cleanup costs, the loss of future income and diminution of the value of its collateral. While the court found that the plaintiff had no standing to rescind the sale, the state version of CERLCA did permit recovery of economic damages resulting from the contamination.

### D. Is the Lender Liable for a Failure to Warn the Borrower?

#### 1. Deficiencies in the Appraisal

Can a lender be liable to the borrower when the real estate appraisal fails to reveal environmental contamination? In *Seats v. Hoover*,[93] 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 its real estate appraisal did not address environmental conditions. In this case, 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 sales contract containing the

90. 577 N.E.2d 992 (Ind. App. 1991).

91. 780 F.Supp. 177 (S.D.N.Y. 1991).

92. 787 F.Supp. 895 (D. Minn. 1992).

93. No. 96-3244, 1999 U.S. Dist. LEXIS 13379 (Aug. 18, 1999).

environmental contingency clause. The appraiser did not observe any adverse conditions. However, the appraiser's report contained an 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 the appraiser 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 that 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, and that the injury resulted from the misrepresentation. The court said that there was a material question as to whether the bank should have known that the appraiser's report might be erroneous and whether the bank gave the appraisal to the plaintiff without the attachment as an inducement to close the loan.

#### 2. Notice to the Borrower of Known or Suspected Risks

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 of the waiver of the environmental due diligence requirement and the possibility of 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. For example, in *Mattingly v. First Bank of Lincol,*[94] 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 as to whether the bank had created a false impression about the environmental condition of the property.

#### 3. Misrepresentation of Risks as Agent of the Owner

Many states have statutes that require owners of property to disclose the existence of contamination to prospective purchasers. While these laws generally do not apply to agents of the sellers, they can be liable under certain circumstances for fraudulent or negligent misrepresentation. For example, in *Ramsden v. Farm Credit Services,*[95] the Wisconsin Court of Appeals allowed a claim for misrepresentation to proceed against an auctioneer of contaminated farmland. In that case, the plaintiffs were the high bidder on a dairy farm sold at a 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, who was 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 the 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 Wisconsin Court of Appeals said that while an agent of the owner does not have an initial duty to disclose knowledge of the property to the plaintiffs (because such a disclosure would be contrary to the interests of its principal), once the agent proceeds to make factual statements he or she has a duty to make truthful statements. Once the agent has chosen to speak, the agent may not omit material facts relevant to conditions of the property that the agent has addressed, if such omissions would foreseeably influence the potential purchaser's decision to purchase.

## XI. CERCLA Liens

### A. Introduction

CERCLA authorizes the EPA to imposed two kinds of liens to recover response costs incurred on a contaminated Property: Non-Priority Liens and Windfall Liens.

### B. Non-Priority Lien

Prior to the 2002 Brownfield Amendments, the EPA was authorized to impose a non-priority lien on property for the full amount of response costs that it incurred at a site and for damage to natural resources against the property of the PRP that is subject to the cleanup (the

94. No. 96-678, 1997 WL 668215 (Sup. Ct. Mont., Oct. 28, 1997).

95. No. 97-2769 (Ct. App. Wisc. Dec.23, 1998).

CERCLA non-priority lien).[96] The lien applies to all of the property owned by the PRP and not just the portion of the site affected by the cleanup. However, the lien is subject to the right of bona fide purchasers and previously perfected interests in the property so it does not act as a "superlien."[97]

The lien becomes effective when the EPA incurs response costs or notifies the property owner of the potential liability, whichever is date is later. Although the lien provision was enacted as part of the 1986 Superfund Amendments and Reauthorization Act (SARA) to CERCLA, it applies to costs incurred prior to the passage of SARA. The lien continues until the PRP resolves its liability or the lien becomes unenforceable though operation of the CERCLA statute of limitations.[98]

The EPA has issued guidance to its regional offices describing the circumstances and procedures to follow for perfection of non-priority CERCLA liens.[99] The guidance indicates that the EPA will perfect its lien when the property is the chief or substantial asset of a PRP, has substantial monetary value, the PRP will likely file for bankruptcy, the value of the property will significantly increase as result of the cleanup, or the PRP plans to sell the property. If the cleanup costs equal or exceed the value of the property, the EPA will not normally file a notice of the lien unless it appears that a secured creditor may foreclose on the property and is not eligible for the secured creditor exemption. The guidance also states that EPA should not file a notice of a lien where it appears that the defendant satisfies the innocent purchaser defense.[100]

The ability of a property owner to challenge the imposition of the CERCLA non-priority lien is extremely limited. Initially, a number of courts had ruled that the CERCLA ban on pre-enforcement review[101] did not deprive the federal judiciary of its jurisdiction to hear challenges to the non-priority lien.[102] In 1991, the United States Court of Appeals for the First Circuit ruled that the EPA must provide minimum procedural safeguards to property owners whose property may be subject to a CERCLA non-priority lien.[103]

In response, the EPA issued revised lien guidance in 1993 to comply with *Reardon*.[104] The guidance provides that the EPA should send a notice by certified mail advising the property owner of the agency's intent to perfect its lien, and the facts supporting the EPA's belief that it may file a lien, and informing the owner that it may submit documentation to the EPA explaining why a lien should not be perfected or requesting an informal hearing before an administrative law judge to determine if the EPA has a reasonable basis to believe that the statutory criterial for perfecting a lien exist. The guidance also provides that the EPA may, under exceptional circumstances, perfect a lien prior to providing the owner with an opportunity to be heard, provided the agency sends a post-perfection notice to the owner immediately upon perfection.[105]

The 1993 Lien Guidance sets forth the factors that a regional judicial officer should consider when determining if the EPA has a reasonable basis to believe that the statutory criteria for perfecting a lien exist. These factors include: whether the property owner was sent notice of the potential lien by certified mail; whether the property is owned by a PRP; whether the property was subject to a response action; whether the EPA has incurred response costs; and whether any other information shows that the lien should not be filed.[106] Because the informal hearing is limited to whether the EPA had a reasonable basis to perfect a lien, the recommendation of the hearing officer does not bar the EPA or the property owner from raising any claims or defenses in later proceedings, nor does the recommendation have any binding effect on the ultimate liability of the property owner.[107] Because of the relatively low burden that EPA has to satisfy, the vast majority of informal hearings have upheld the EPA's determination that it may impose a lien on the property.[108] Proposed liens have been upheld where the EPA has not identified other PRPs who contributed to the contamination.[109] The EPA

96. 42 U.S.C. § 9607(l).

97. *Id.* § 9607(l)(3).

98. 42 U.S.C. §9607(l)(2).

99. For EPA guidance on the CERCLA Non-Priority Lien, *see* "Guidance on Federal Superfund Liens," Memorandum form Thomas L. Adams, Jr., Asst. Administrator, Office of Enforcement and Compliance Monitoring (Sept 22, 1987) (1987 Lien Guidance); and "Supplemental Guidance on Federal Superfund Liens," Memorandum from William A. White, Enforcement Counsel, Office of Enforcement/Superfund, and Bruce M. Diamond, Director, Office of Waste Programs Enforcement (July 29, 1993)(1993 Lien Guidance).

100. 1987 Lien Guidance at 3-4.

101. 42 U.S.C. § 9613(h).

102. Barmet Aluminum Corp. v. Reilly, 927 F.2d 289 (6th Cir. 1991); South Mascomb Disposal Authority v. U.S., 681 F.Supp. 1244 (E.D.Mich. 1991); Juniper Development Group v. U.S., NO. 89-375 (D.Ariz. April 26,1990).

103. Reardon v. United States, 947 F.2d 1509 (1st Cir. 1991).

104. *Id.* At least one federal court has upheld the lien perfection procedures established in the 1993 Lien Guidance as satisfying the Due Process Clause of the Fifth Amendment, concluding that the procedures do not amount to an unconstitutional taking of a substantial property interest. U.S. v. 150 Acres of Land, More or Less, 3 F.Supp. 2d 823 (N.D. Ohio 1997).

105. The guidance contains a non-exclusive list or "exceptional circumstances such as imminent bankruptcy of the owner, imminent transfer of all or part of the property, imminent perfection of a secured interest that would subordinate EPA's lien or an indication that these events are about to take place. 1993 Lien Guidance at 5-6.

106. 1993 Lien Guidance at 7.

107. 1993 Lien Guidance at 9.

108. *In the Matter of* Herculaneum Lead Smelter Site, CERCLA Lien Recommended (Region VII, Feb. 12, 2003); *In the Matter of* Mercury Refining Superfund Site, CERCLA Lien Recommended (Region 2, June 11, 2002); *In the Matter of* Scorpio Recycling Site, CERCLA Lien Recommended (Region 2, July 2, 2002); *In the Matter of* Prestige Chemical Site, CERCLA Lien Recommended (Region 4, Mar. 26, 2002); *In the Matter of* Exact Anodizing Superfund Site, CERCLA Lien Recommended (Region 2, Feb. 14, 2002); *In the Matter of* Quantum Realty Company, L.C.-Hudson Refining Superfund Site, CERCLA Lien Recommended (Region 6, Oct. 3, 2001); *In the Matter of* Eastland Woolen Mille Site-Estate of Ralph A. Berg, CERCLA Lien Recommended Decision (Region I, Aug. 10, 2001); *In the Matter of* the Asbestos Dump-Millington Site, CERCLA Lien Recommended Decision (Region 2, May 16, 2001); *In the Matter of* Iron Mountain Mines, Inc., Determination of Probable Cause (Region 9, May 4, 2000); *In the Matter of* Maryland Sand Graveland Stone Company, CERCLA lien Recommended (Region 3, June 22, 1999); *In the Matter of* Copley Square Plaza Site, CERCLA Lien Recommended (Region 5, June 5, 1997); *In the Matter of* Avanti Site, Probable Cause Determination (Region 5, Feb. 4, 1997); *In the Matter of* Paoli Rail Yard Superfund Site, Determination of Probable Cause (Region III, Nov. 30, 1995); *In the Matter of* Bohaty Drum Site, CERCLA Lien Recommended (Region 5, June 22, 1995); *In the Matter of* Harbucks, Inc.-Revere Chemical Site, Probable Cause Determination (Region III, Nov. 2, 1994); *In the Matter of* CrycoChem, Inc., Probable Cause of Determination (Region III, Nov. 29, 1993); *In the Matter of* the Harvey and Knotts Drum Site, Probable Cause Determination (Region III, Nov. 10, 1991); *In the Matter of* Picollo Farm Superfund Site, CERCLA Lien Recommended Decision (Region 1, Aug. 27, 1991).

109. *In the Matter of* Picollo Farm Superfund Site, CERCLA Lien Recommended Decision (Region 1, Aug. 27, 1991).

has not been required to file a cost-recovery action prior to perfecting a CERCLA non-priority lien and has been allowed to perfect a lien, even where a cost-recovery proceeding is pending.[110]

There has been only one reported instance where an informal hearing did not uphold the EPA's proposed lien.[111] In that case, the EPA sought to impose a lien on all parcels where the PRP had conducted operations. However, the hearing officer concluded that the EPA had not conducted removal actions on twenty-two acres, but upheld perfection of the lien on the other sixty-one acres.

### C. Windfall Lien

The 2002 Brownfield Amendments added a second lien provision to make sure that a BFPP does not become unjustly enriched at the taxpayers' expense. Section 107(r) of CERCLA authorizes the EPA to impose a windfall lien on property owned by a BFPP under certain circumstances.[112] To perfect a windfall lien, the EPA must establish that it has performed a response action, has not recovered its response costs, and that the response action increased the fair market value of the property above the fair market value of the facility that existed before the response action was initiated.

The windfall lien will arise at the time the EPA incurs its costs but will not be effective until the EPA perfects the lien by filing it in the local land records. The windfall lien continues until it is satisfied by sale or other means, or the EPA recovers all of its response costs incurred at the property.

The windfall lien will be capped by the amount of unrecovered response costs and will not exceed the increase in fair market value of the property attributable to the response action at the time of a sale or other disposition of the property. This is in contrast to the CERCLA non-priority lien where the EPA may file a lien for all of its response costs for a particular site.

The possibility of a windfall can inject uncertainty into a real estate transaction. For example, the EPA is not required to notify a property owner when it incurs costs that may be eligible for a windfall lien. Instead, the windfall lien becomes effective when the EPA incurs the costs. Since the windfall lien provision has no statute of limitations, the parties may not know the extent of the EPA's past response costs. In addition, the parties may not know how much of the current property value the EPA may attribute to its response action. Moreover, a purchaser may not know if it qualifies as a BFPP at the time of the closing and, therefore, may not know if is potentially vulnerable to a windfall lien. Finally, a party may inadvertently fail to maintain its status as a BFPP after taking title, thereby nullifying the windfall lien.

In July 2003, the EPA issued its interim windfall lien guidance clarifying when the agency plans to exercise its authority to impose a windfall lien and how it plans to calculate the amount of the windfall lien (the Windfall Lien Guidance).[113]

The Windfall Lien Guidance provides indicates that the decision to perfect a windfall lien will be based on site-specific factors, but does not provide examples of factors that could influence the EPA's exercise of its enforcement discretion. Moreover, unlike the guidance for the CERCLA non-priority lien, the Windfall Lien Guidance does not discuss how or if it agency intends to notify a BFPP of the existence of a potential Waterfall Lien. To qualify as a BFPP, a party may not have a "financial relationship" with the seller or the liable party. The Windfall Lien Guidance does not shed any light or provide a mechanism for allowing a purchaser to determine if it would be a BFPP who might be potentially subject to a windfall lien. For example, if the seller or one of the liable parties for the site is a publicly-traded company and the purchaser owns a non-controlling interest in that entity, does this "financial relationship" disqualify it as a BFPP?

On the other hand, there may be instances when a prospective purchaser may want to forgo its status as a BFPP and either accept the risk that it will be a CERCLA liable party or negotiate some other risk-transfer mechanism such as insurance. However, the Windfall Lien Guidance does not provide a mechanism for a purchaser to disqualify itself as a BFPP short of deliberately failing to comply with its Continuing Obligations.

### D. Perfecting the Windfall Lien

In general, the EPA will not perfect a windfall lien if all of the increase in the fair market value (FMV) of the property was due to a response action performed by EPA prior to purchase by the BFPP.[114] The EPA will also generally not perfect a windfall lien when the BFPP acquired the property at FMV after the cleanup since there would not be any windfall to the BFPP.[115] If the remedy was constructed prior to acquisition but some response actions must continue after the closing such as operation and maintenance activities, the EPA generally will not perfect a windfall lien for those activities since they would not likely have any impact on the FMV of the property.[116] The EPA will also not seek a windfall lien when there is a substantial likelihood that

110. *In the Matter of* Iron Mountain Mines, Inc., Determination of Probable Cause (Region 9, May 4, 2000); *In the Matter of* Paoli Rail Yard Superfund Site, Determination of Probable Cause (Region III, Nov. 30, 1995);

111. *In the Matter of* Pacific States Steel Removal Site, CERCLA Probable Cause Determination (Region 9, Aug. 14, 1995). Other hearings have found removal actions were conducted on non-contiguous parcels because EPA had at least performed intrusive sampling or located its removal action office on the non-contiguous parcel. As a result, EPA was allowed to perfect a lien on those other parcels. *In the Matter of* Mercury Refining Superfund Site, CERCLA Lien Recommended (Region 2, June 11, 2002); *In the Matter of* Maryland Sand Gravel and Stone Company, CERCLA Lien Recommended (Region 3, June 22, 1999).

112. 42 U.S.C. § 9607(r). Interestingly, section 107(r) does not expressly state that the windfall lien is subject to the rights of holders of previously perfected security interests.

113. "Interim Enforcement Discretion Policy Concerning "Windfall Liens" Under Section 107(r) of CERCLA," Memorandum form Susan E. Bromm, Director of the Site Remediation Enforcement, U.S. EPA, July 16, 2003.

114. Windfall Lien Guidance at 4.

115. Windfall Lien Guidance at 5.

116. Windfall Lien Guidance at 5.

it will recover all of its costs from liable parties, such as when it has entered into a consent decree or settlement agreement with the liable party.[117]

The EPA will also decline to perfect a windfall lien if it has previously filed a CERCLA non-priority lien and has entered into a settlement with a prior owner to satisfy that lien.[118] The EPA expects a BFPP acquiring a property subject to a CERCLA non-priority lien would normally resolve the lien as part of the real estate transaction, either by a settlement with the agency or a reduced purchase price to reflect the value of the CERCLA non-priority lien. If the CERCLA non-priority lien is not resolved at the closing, the EPA has indicated that it would probably pursue cost-recovery after the closing or commerce an *in rem* action against the property.[119]

However, the Windfall Lien Guidance cautions that there might be instances where the EPA may seek to perfect a windfall lien even when the increase in FMV occurred prior to the BFPP acquisition. Factors that could cause the agency to perfect a windfall lien under such circumstances include cases: where the EPA has substantial unreimbursed costs; when the EPA's cleanup action resulted in a significant increase in the property's fair market value; where there are no viable and liable parties from whom the agency could recover costs; and where the response action occurred while a non-liable party owned the property. One such example would be if a lender qualifying for the secured creditor exemption foreclosed on contaminated property while the EPA performed a response action that substantially increased the property's FMV. Under such circumstances, the EPA indicates that it might file a windfall lien, particularly if the lender received sales proceeds that exceeded the value of its security interest.[120]

The EPA has also warned that it might seek to perfect a windfall lien if a party has attempted to complete a transaction or a series of transaction designed to avoid CERCLA liability. The Windfall Lien Guidance indicates that the EPA will pay particular attention to transactions that appear to provide a windfall to a BFPP, or appear to be structured to limit the EPA's ability to recover its costs against the seller (*e.g.*, disposing of valuable assets so that the seller no longer has funds to pay the EPA, or conveying the property to evade perfection of a lien). If the BFPP did not acquire the property below the FMV, EPA may seek any of the windfall attributable to its response actions.[121] For example, if the EPA expends $3 million on a site and the cleanup increases the FMV from $1 million to $2 million, a BFPP then acquires the land for $500,000 and the EPA then spends an additional $1 million, which increases the FMV to $2.5 million: Because the BFPP acquired the property below the FMV, the EPA would seek the $1.5 million increase in FMV.[122]

The Windfall Lien Guidance also identifies two kinds of expenditures which the EPA will generally not seek to recover by perfecting a windfall lien, even if they result in an increase in FMV. The EPA will not perfect a windfall lien for the amount of any brownfield grant or loans awarded for the site.[123] In addition, the EPA will not seek a windfall lien when its only costs are for performing a preliminary site assessment or site investigation, and the agency does not anticipate performing any removal or remedial actions.[124]

The EPA also has indicated that it will not seek to perfect a windfall lien when the BFPP acquires the property for two types of uses. The first excluded use is when the BFPP plans to use the property for residential purposes, provided that the seller and the BFPP are non-governmental and non-commercial entities (*i.e.*, homeowner-to-homeowner sales.)[125] The second excluded use is when the BFPP acquires the property to create or preserve a public park, greenspace, recreational, or similar public purpose. However, if the public use is only temporary and then is converted to a different use, the EPA may consider perfecting a windfall lien.[126]

The EPA may also decline to perfect a windfall lien when prior enforcement discretion policies might apply to the BFPP. For example, the EPA has indicated that it would not generally perfect a windfall lien against a BFPP that acquires property that otherwise qualify for the Residential Property Owner Policy. This policy applies to property with a contaminated aquifer from an off-site source[127] or where the seller has previously been issued a comfort letter from the EPA.[128]

The Windfall Lien Guidance does not indicate if a statute of limitations applies to the windfall lien. However, EPA personnel have said in conferences moderated by your author that the agency does not intend to resurrect all of its "old and cold" costs but only seeks to recoup those costs that result in a windfall for the BFPP.

### E. Calculating the Windfall Lien

Generally the EPA will only seek the amount of the increase in FMV attributable to a response action that occurs after a BFPP acquires the property at

117. Windfall Lien Guidance at 7.

118. Windfall Lien Guidance at 11.

119. Windfall Lien Guidance at 12.

120. Windfall Lien Guidance at 4.

121. Windfall Lien Guidance at 10.

122. Windfall Lien Guidance at 9.

123. Windfall Lien Guidance at 5.

124. Windfall Lien Guidance at 6.

125. Windfall Lien Guidance at 6. The EPA said this was consistent with its "Policy Towards Owners of Residential Property at Superfund Site," Memorandum from Don Clay, Assistant Administrator, Office of Solid Waste and Emergency Response, and Raymond Ludwiszewski, Acting Assistant Administrator, Office of Enforcement (July 3, 1991) (Residential Property Owner Policy).

126. Windfall Lien Guidance at 7.

127. "Policy Towards Owners of Property Containing Contaminated Aquifers," Memorandum from Bruce M. Diamond, Director, Office of Site Remediation Enforcement (May 24, 1995).

128. Windfall Lien Guidance at 7. EPA cautioned that the seller received a comfort letter but the agency subsequently expended significant funds to cleanup a site after a BFPP acquired title, the EPA might pursue a windfall lien against the BFPP since the cleanup would not have been anticipated at the time the comfort letter was issued.

FMV. The Windfall Lien Guidance states that if a CERCLA non-priority lien or a windfall lien has not been filed against the property, BFPPs should be able to take title with the understanding that the EPA will only seek the increase in FMV if the agency subsequently performs a response action. However, the EPA also has emphasized that if it is required to enforce its windfall lien through litigation, the agency may seek all of its costs and not just those attributable to the increased FMV.[129]

Unfortunately, the Windfall Lien Guidance does not shed much light on how the FMV should be calculated. Instead, the EPA simply states that it will compare the FMV of the site in a clean condition to the FMV when the property was purchased. There are a number of ways to calculate the FMV but the Windfall Lien Guidance does not explain how the agency plans to distinguish between the FMV attributable to a response action as opposed to that resulting from market conditions or from neighborhood redevelopment projects. Often the mere creation of a redevelopment plan for a formerly blighted area can result in increased property values. In a recent conference call moderated by your author, EPA representatives said that the EPA does not have any formula that it will use nor does it plan to issue any guidance on the form or content of appraisals that are to be used for determining FMV. Instead, the agency will rely on case law, carefully review individual appraisals, and take a close look at what factors are affecting property valuations.

If the BFPP believes there is a potentially significant windfall resulting from a post- acquisition EPA-funded cleanup, the agency recommends that the BFPP obtain a reliable estimate of the property's FMV in its remediated condition. The estimate should be based on a real estate appraisal by a trained professional, though the EPA has suggested that other credible mechanisms for determining the FMV in its clean condition might be appropriate, such as a tax appraisal or information from neutral professional real estate brokers.

The Windfall Lien Guidance also does not discuss whether the EPA plans to establish any procedures for contesting FMV estimates. In a recent conference call moderated by your author, EPA representatives said that the EPA would try to resolve these disputes through negotiation. If FMV disputes cannot be resolved, the agency would likely send a referral to the United States Department of Justice to file a declaratory relief action to determine the FMV.

### F. Resolving Windfall Liens

The EPA hopes the Windfall Lien Guidance will limit the need for the agency to become involved in private real estate transactions. However, the agency acknowledged that there might be site-specific circumstances that will require some assurance from regional offices. The EPA anticipates that this could be accomplished by issuance of comfort letters under the EPA's comfort/status letter policy.[130] However, the Windfall Lien Guidance suggests that the use of such letters should be limited to situations and projects found to be in the public interest or where there is no other mechanism to adequately address the concerns of the party requesting the assurances from the EPA.

For situations where the EPA is likely to perfect a windfall lien, the EPA and the Department of Justice have developed a model settlement agreement to facilitate resolution of windfall liens. The model agreement provides that the federal government will release and waive a windfall lien in exchange for payment of cash or other appropriate considera-tion such as performance of additional response actions. The agreement will require the BFPP to: provide the EPA with an irrevocable right of access and ensure that any tenants or subtenants provide such access; file a notice of the agreement in the land records and provide a copy to any tenants or subtenants; comply with any land use restrictions or engineering controls; and take all steps necessary to maintain its status as a BFPP. Interestingly, the windfall lien model agreement does not contain a covenant not to sue (CNTS) which typically appears in a Prospective Purchaser Agreement (PPA).

While the EPA has indicated that it will generally not enter into PPAs, there have been instances where the agency has agreed to issue PPAs for sites with significant public interest. Because of the absence of CNTS in the windfall lien model agreement, BFPPs of sites where redevelopment is a high priority to local governments should explore the possibility of using a PPA as a mechanism for removing or eliminating a potential windfall lien. In such circumstances, it would be advisable to have local government officials contact the EPA about the need for a PPA. The EPA should also be advised if the key lender for the redevelopment is insisting on a CNTS.

In lieu of the EPA imposing a windfall lien on the property, the EPA is authorized to accept a lien on any other property that the BFPP owns or to allow for some other form of assurance of payment in the amount of the unrecovered response costs that is satisfactory to the EPA.

## XII. State Superlien Laws

Nearly two-dozen states have non-priority environmental lien laws that operate in the same manner as general commercial liens.[131] The cleanup costs

129. Windfall Lien Guidance at 8.

130. "Policy on the Issuance of Comfort/Status Lenders," Memorandum from Steve A. Herman, Assistant Administrator, Office of Enforcement and Compliance Assurance (November 8, 1996), *reprinted at* 62 Fed. Reg. 4,624 (Jan. 30, 1997).

131. Alaska Stat § 46.08.075; Ariz. Rev. Stat § 49-295; Ark. Stat Ann. § 8-7-417(a), Cal. Health & Safety Code § 25365.6(a), Cal. Water Code 13304(c)(2); Fla. Stat. § 376.308(3)(c); 415 ILCS 5/21.3; Ind. Code § 13-7-8.7- 10.7(a); Iowa Code. Ann. 455B.396; Ky. Rev. Stat. Ann. 224.01-400(23)(a); La Rev. Stat. Ann. 30.1149.7(f); Md. Health and Environment Title 7-266(b)(5); Minn. Stat. Ann. 514.672; Montana, M.C.A. § 75-10-720; New York, N.Y. Nav. Law. § 181-a-e; Ohio Rev. Code Ann. § 3734.20(B), 3734.22 and 3734.26; Ok. Stat. Ann. tit. 63, § 1-1011; Ore. Rev. Stat 466.205, 465.335 and 466.835; Pa. Stat Ann. Tit. 35,6020.509; R.I. Gen. Laws § 23.19.14-15;

*(Continued on next page)*

incurred by environmental agencies in those states take precedence over all other claims except previously perfected security interests.

In addition, approximately eight states have enacted so-called "Superlien" provisions within their mini-Superfund laws.[132] These laws, initially adopted to ensure that states could recover the costs of publicly-financed cleanups of hazardous waste sites, grant a first-priority lien on various assets of PRPs equal to the amount of the cleanup expenditures incurred by the state; these liens are superior to previously perfected mortgages and security interests.

The Superliens not only subordinate the rights of lenders with previously perfected security interests, but also subordinate the rights of a bona fide purchaser who bought property without notice of the contamination or who acquired title through abandonment, foreclosure, deed in lieu of foreclosure, or bankruptcy order. In addition, these laws can jeopardize the solvency of de minimis PRPs whose limited assets may be attached despite their tenuous connection to a hazardous waste site.

Interestingly, only a limited number of these liens have actually been filed. Instead, states are prospectively wielding these laws like the sword of Damocles over the assets of the PRPs in order to extract concessions in privately-financed settlements. Nevertheless, it is extremely important that corporate managers, lenders, and their counsel be aware of the requirements of these laws and the risks they represent.

These "Superlien" laws vary considerably from state to state. Some of the Superlien statutes merely impose a priority lien on the property which is subject to the cleanup while others attach to all of the assets of the responsible party, including personal property and business revenue located in or derived from the state.

While some state Superliens only become effective after the lien has been recorded, several states permit a "secret" Superlien, which attaches to the property before public notice of the lien is filed. These are particularly onerous provisions because a prudent lender who diligently searches the public records may nevertheless find its interest subordinated by the "hidden" Superlien. Finally, some states permit the Superlien to apply retroactively and to prevail over security interests that were perfected before the Superlien law was enacted.

## XIII. Legacy Risk

Lenders are also facing increased potential for environmental risk from loans on properties acquired during mergers or acquisitions. Banks that did not perform thorough environmental due diligence during bank consolidations have found themselves saddled with environmental liability. The following are two recent examples.

The EPA recently added the Swan Cleaners/Sun Cleaners Area Ground Water Plume site in Wall Township, New Jersey to the NPL. Two dry cleaners had formerly operated at the site which is currently a bank branch office owned by the Bank of America (BOA). The dry cleaners discharged Tetrachlooethylene (PCE) into the on-site septic system where it eventually migrated into the groundwater that serves public and private drinking water wells within a four-mile radius. PCE was detected at concentrations of up to 200 parts per million (ppm) in the groundwater. The PCE-contaminated groundwater may also be impacting surface water and groundwater. In addition, following indoor air sampling of 300 residential and commercial properties in 2001, the EPA has had to install ventilation systems in the basements of nine homes and one ventilation system on a commercial property. This property was acquired by Summit Bank when it purchased the property. Fleet Bank then took title to the property when it acquired Summit Bank. Fleet then merged with BOA. Apparently, none of the banks performed the kind of environmental due diligence that they customarily expect from their borrowers.

In another example, a major money center bank received a demand letter from the New Jersey Department of Environmental Protection (NJDEP) for reimbursement of $598,000 in past cleanup costs and $5.7 million in natural resources damages. The NJDEP alleged that the bank was strictly liable under the state Spill Compensation and Control Act (Spill Act) because a predecessor had held title to the contaminated property form October 1975 to July 1977.

In this case, a finance company (Finance Company) extended a loan to a former dry cleaner in 1974 that was secured by, inter alia, a second mortgage on the property. After the borrower defaulted on its loan, the holder of the first mortgage commenced a foreclosure action. The Finance Company purchased the property at the foreclosure sale for $57,300. After holding title for eighteen months, the Finance Company sold the property for $66,000. In 1983, the Finance Company was acquired by another credit company (Credit Company) and operated as a subsidiary. The major money center bank (Bank) purchased the stock of the Credit Company in 1987.

In 1986, the Ocean Township Health Department discovered that drinking water wells in Dover Township were contaminated with Tetrachloroethylene (PCE) from the dry cleaning business. The NJDEP imposed a well restriction area (WEA) and recommended that all impacted proprieties seal their wells and connect to the municipal water supply system. Public funds were used to extend the municipal drinking water system. The NJDEP then issued a demand to the current and former owners and operators of the property.

The NJDEP alleged that the Bank was a prior owner because it was a successor to the Finance Company. After receiving the NJDEP demand, the Bank's counsel advised the NJDEP that the Bank should not be liable because it fell within the

131. *(Continued from previous page)*

South Dakota, S.D. Codified Laws Ann., § 34A-12-13; Tenn. Code Ann. 68-212-209(d); Texas Health & Safety Code Ann. § 361.194; Va. Code Ann. 10.1-1406(c) (repealed); Washington, RCW § 70-105B (repealed).

132. Conn. Gen. Stat. 22a-452a; La. Rev. Stat. Ann. § 30:2281; Me. Stat. Ann. tit. 38, sect. 1370, 1306-C, 1362; Mass. Ann. Laws ch. 21E, sect 13; Mich. Comp. Laws Ann. 324.20138; N.H. Rev. Stat Ann. § 147-B: 10-b; N.J.S.A. 58:10-23.11f and Wis. Stat. § 144.442(9)(i).

Spill Act's secured creditor exemption. The Bank's counsel indicated that the Finance Company foreclosed on the property to protect its security interest, that there was no evidence that the Finance Company ever participated in the management of the dry cleaner, and that selling the property within eighteen months satisfied the requirement of the Spill Act's secured creditor exemption that a foreclosing lending institution dispose of the property in a "reasonably expeditious" manner. The NJDEP agreed to not to pursue the Bank in the agency's cost recovery action.

This case illustrates two important points. First, it is important for lenders to assess potential legacy issues when contemplating a merger with another financial institution. The liability at issue here involved a transaction that took place nearly thirty years ago. Second, the Bank benefitted from case law holding that the Spill Act's secured creditor exemption could be applied retroactively. The secured creditor exemption was added to the Spill Act in 1993. Because the legislative history indicated that this was a curative amendment, courts have interpreted the exemption to apply to the initial enactment of the Spill Act. Thus, in determining how much diligence to conduct for legacy issues, lenders should determine when any state lender liability safe harbor became effective.

# EPA Promulgates Final Rule Regarding "All Appropriate Inquiry" Standard under CERCLA

By Elwood F. Cahill, Joshua S. Force and Chad P. Morrow*

## I. Introduction

On November 1, 2005, the United States Environmental Protection Agency (the EPA) promulgated its final rule on "Standards and Practices for All Appropriate Inquiries" in connection with defenses to potential liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).[1] Under CERCLA, both the current owner or operator of a facility from which a hazardous substance has been released and the owner/operator at the time of disposal are strictly liable for remediation of the hazardous substances at the property. Each has a defense to liability, however, based on its status as an "innocent landowner." An innocent landowner is one who (1) acquires property after hazardous substances have been placed on it and (2) did not know or have reason to know that the property was in fact contaminated. To assert this defense, before its acquisition of the property, the purchaser must perform "all appropriate inquiry" (AAI) into the prior ownership and uses of the property consistent with customary commercial practices. Unfortunately, the scope of AAI was not defined in CERCLA. Rather, the industry standard of AAI was developed by the American Society of Testing and Materials (ASTM) as ASTM Standard E1527-00.

## II. Background

In 2002, Congress charged the EPA with developing regulations setting forth exactly what activities constitute AAI. On August 26, 2004, the EPA published its proposed "Standards and Practices for All Appropriate Inquiries" and received more than 400 comments from the public. Generally, the standards set forth in the proposed rule imposed a more comprehensive and thorough standard for the conduct of routine Phase I environmental site assessment reports (ESAs). Significant differences between the proposed rule and the then-current industry standard (ASTM E1527-00) included: (1) setting minimum educational and experience qualifications for "environmental professionals"; (2) standardizing reliability and expiration of ESAs; (3) shifting the goal of ESAs from identification of "recognized environmental conditions" to identification of the presence of any releases or threatened releases of hazardous substances; (4) requiring more in-depth interviews of past and present owners, occupants, managers and neighbors of property with respect to past activity; (5) expecting a prospective purchaser to be bound by its level of sophistication (more specifically, requiring a level of inquiry in accordance with any "specialized knowledge or experience" held by the party seeking to assert the defense); and (6) expanding historical searches to the inception of property use and development.

## III. The Final Rule

The final rule leaves most of the relevant provisions of the proposed rule intact, but a number of revisions were made based on the public comments. Among the changes, the final rule relaxes the educational and experience requirement by allowing a person without a college degree but with ten or more years of full-time experience in conducting environmental assessments and related activities to qualify as an "environmental professional." Also, though a prospective purchaser is still required to collect certain types of information consistent with a party with its level of sophistication, the decision whether to communicate this information to the environmental professional is left to the purchaser's discretion. Nevertheless, any information not furnished to the environmental professional that may affect his ability to analyze the property would be identified as a data gap, and the environmental professional would be obligated to comment on the significance of the gap. The final rule omits further the requirement set forth in the proposed rule that a search be conducted for institutional and engineering controls located on adjoining properties. Lastly, the final rule provides that persons conducting AAI may comply with the final rule by performing all diligence in accordance with ASTM E1527-05, a recently adopted ASTM standard.

Notably, the final rule also clarifies that the ESA must be conducted within one year before the date of acquisition of the subject property. Notwithstanding the one-year requirement, the final rule provides that the following components of the AAI must be conducted or updated within 180 days of, and before, the acquisition of the property:

- interviews with past and present owners, operators and occupants;
- searches for recorded environmental clean-up liens;
- reviews of federal, tribal, state, and local government records;
- visual inspections of the facility and adjoining properties; and
- the declaration by the environmental professional.

*(Continued on page 193)*

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1. 40 CFR Pt. 312.