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Environmental Liability

Lender That Took Environmental Actions on Defaulted Borrower's Facility Was Not an Operator under CERCLA

By Lawrence P. Schnapf, Schulte, Roth & Zabel, New York

A federal district court in Michigan recently ruled that a bank that conducted an environmental assessment, reported a release of hazardous substances to a state authority, and removed underground storage tanks (USTs) located at a borrower's facility was not liable as a site operator for remediating the property.

The decision should be reassuring to lenders since it shows that even though EPA's Lender Liability Rule is no longer in effect, its principles may still be used by courts in determining whether or not financial institutions are liable for site cleanup.

In addition, the ruling is consistent with the requirements of EPA's proposed Resource Conservation and Recovery Act (RCRA) Lender Liability Rule regarding USTs.

In *Z&Z Leasing v. Graying Reel Inc.,* in 1985, Z&Z Leasing acquired

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property formerly owned and operated by Mill & Abrasive Supply Inc. and constructed a 70,000-square-foot industrial facility, financed by industrial revenue bonds. To obtain the bond financing, Z&Z obtained a letter of credit from Manufacturers National Bank (MNB) of Detroit and executed a reimbursement agreement. To secure its obligations under the agreement, Z&Z granted MNB a security interest in all of its accounts receivable, inventory, and machinery and equipment, as well as the mortgage on the property.

In March 1991, MNB conducted a follow-up environmental assessment which confirmed the presence of a UST. The bank's environmental consultant collected samples from the UST which revealed that it contained solvents and other hazardous substances.

One month later, Z&Z defaulted on its bond payment. MNB paid the amount due pursuant to its letter of credit and then filed a complaint against the borrower seeking immediate possession of all of the borrower's collateral.

Settlement Agreement

On July 2, 1991, Z&Z and MNB entered into a settlement agreement in which Z&Z agreed to try to sell the collateral. If the proceeds of the sale did not reduce the indebtedness below $487,500, then a consent judgment would be entered in favor of the bank, which would give MNB title to Z&Z's unsold personal property. If Z&Z was able to reduce the debt below the threshold, MNB would grant Z&Z an extension to repay the remainder of the loan. Z&Z also agreed to maintain the property in compliance with environmental laws, and MNB advanced the borrower $15,000 to remove the UST.

By October 31, 1991, Z&Z had sold all of its machinery and equipment and had reduced its indebtedness below the threshold. However, Z&Z never made any of the interest payments required during the extended repayment period provided for in the settlement agreement. Despite this default, the bank never took any action to foreclose on the property.

Z&Z alleged that the bank, by virtue of its mortgage was an owner of the property under CERCLA.

Bank Sued as Owner and Operator

In July 1993, Z&Z commenced a contribution action against the former owners of the site because of the environmental contamination. In 1994, Z&Z also sued the bank, claiming the bank was an owner and operator under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and was responsible for the cleanup of the property. The bank, in turn, sought to have the action dismissed through a summary judgment action.

Z&Z alleged that the bank, by virtue of its mortgage, had indicia of ownership over the prop-

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erty and the UST and was therefore an owner of the property under CERCLA. However, the court said that under Michigan law, a mortgage only granted a bank a lien against the real estate securing the loan and not title to the property. Furthermore, the court found that the bank did not take any action to obtain title, because the consent judgment was never entered and the bank never took possession of the property. Therefore, the bank was not an owner under CERCLA.

Z&Z also argued that the bank was a facility operator, as defined by CERCLA, on a number of grounds. For instance, it argued that the actions the bank took regarding the UST amounted to participation in the hazardous waste management of the facility.

However, the court ruled that the bank's actions were for the sole purpose of protecting its security interest, and that any other ruling would eviscerate the secured creditor's exemption.

Financial Management

The court then turned to Z&Z's claim that the 1985 reimbursement agreement had effectively transferred financial management of the operation to the bank. Z&Z argued that pursuant to terms of that agreement, it could not take certain actions without the approval of the bank. These actions included merging with another firm, selling assets, making loans, declaring or paying dividends, and purchasing or leasing fixed assets.

However, the court said that lenders frequently have some routine involvement in the financial affairs of their borrowers to ensure that the bank's interests are adequately protected, and that imposing liability on a lender for having these covenants written into their agreements would punish a bank for engaging in its normal course of business. The court also said that a bank must have the right to monitor any aspect of a borrower's business without running the risk of incurring liability.

The court rejected the claim that provisions in the security agreement requiring the borrower to comply with environmental laws rendered the bank liable.

Finally, the court rejected the claim that provisions in the security agreement requiring the borrower to comply with environmental laws rendered the bank liable. The court said that the bank's requiring its borrower to abide by environmental laws did not constitute involvement in the hazardous waste management of the business. The court said that this was simply prudent action to protect the bank's security interest, and that the bank should not be held liable for insisting that its borrower obey the law.

Implications of the Decision

This decision is consistent with prior caselaw, which distinguishes prudent fiscal oversight of a borrower's operation as opposed to excessive entanglement with the day-to-day management of the borrower's operation. It is also in line with the majority view that a bank should not be held liable as an operator of a borrower's facility simply because loan covenants may give a bank an ability to control the borrower's operations.

The case indicates the wisdom of not foreclosing on contaminated property.

Under EPA's Lender Liability Rule that was struck down last year by the District Court in the District of Columbia, lenders who, to abate environmental conditions, took actions that did not make conditions worse would not be held liable as facility operators. Without referring to the vacated rule, the *Z&Z* court came to the same conclusion. Borrowers who default on loans often leave hazardous substances on their premises. Lenders are then fearful of taking control of the premises and removing the hazardous materials for fear of incurring liability for all of the environmental problems at the site. If this case is followed by other jurisdictions and if EPA promulgates its RCRA Lender Liability Rule for USTs, lenders will be able to take actions that protect the environment without fearing that they have jeopardized their immunity from CERCLA liability.

Finally, the case indicates the wisdom of not foreclosing on contaminated property. If a bank engages in customary fiscal oversight of its borrowers' operations and does not foreclose or take possession of the contaminated property, the trend of recent cases suggests that lenders should have the benefit of the "safe harbor" of the secured creditor exemption. (*Z&Z Leasing v. Graying Reel, Inc.*, No. 94-CV-73636-DT (WD Mich. Jan. 13, 1995))