Analysis&Perspective

With the enactment of federal lender liability protections,[1] many financial institutions have become less concerned about environmental issues associated with the lending transactions. Indeed, some lenders have begun to relax their environmental due diligence requirements.

Several cases decided during the past year, however, call into question the wisdom of this lax approach. These decisions show that banks can continue to be exposed to environmental liability even when they comply with the requirements of the Lender Liability Amendments or comparable state laws.

This article will examine those recent lender liability cases and provide advice for practitioners counseling lenders on how to avoid liability for environmental pollution.

LENDERS FACE CONTINUED EXPOSURE TO ENVIRONMENTAL LIABILITY

BY LARRY SCHNAPF *

The Lender Liability Amendments added new provisions to secured creditor exemptions in CERCLA and the Resource Conservation and Recovery Act[2] and codified the principles contained in the corresponding regulations promulgated by the Environmental Protection Agency.

These regulations essentially provide that a lender must exercise actual day-to-day control over a borrower's operation before it will be considered "participating in the management of a facility." Moreover, lenders are allowed to foreclose on property without becoming liable as an owner so long as they expeditiously take steps to sell the property and comply with environmental laws while they are in possession of the property. Most states have enacted their own versions of these statutes.

However, as we warned lenders last year,[3] the Lender Liability Amendments fall short of providing complete immunity from environmental liability because they provide no relief from claims brought under state environmental and common laws. The cases surveyed below highlight issues legal advisors must keep in mind when dealing with transactions involving contaminated property.

Mattingly v. First Bank of Lincoln

A contaminated gasoline station was at the center of the controversy in this case.[4] In July 1983, a construction crew installing a new sewer line in the center of Lincoln, Mont., discovered a pocket of gasoline floating on the groundwater. An investigation by the state Water Quality Bureau (WQB) identified three gasoline stations as the source of the contamination. One of these stations was an Exxon station owned by August Habet. Another was a Handi-Mart owned and operated by a director and active board member of the First Bank of Lincoln (FBOL). After determining that the leading edge of the groundwater extended to the FBOL office site, the state and obtained permission from bank's president to excavate a portion of the office site to determine the extent of the zone of contamination.

[1] Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996, Pub. L. 104-208, Subtitle E, 110 Stat. 3009 (September 30, 1996) (codified at 42 U.S.C. 9601(20)(A)) (the "Lender Liability Amendments" to the Comprehensive Environmental Response, Compensation, and Liability Act) (42 U.S.C. 9601 et seq.) (CERCLA or the federal superfund law).

[2] 42 U.S.C. 6901 et seq.

[3] See "Congress Amends CERCLA To Expand Lender Liability Protection," 11 TXLR 882 (January 15, 1997).

[4] No. 96-678, 1997 WL 668215 (Mont SupCt, Oct. 28, 1997).

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Four years later, the plaintiff agreed to purchase the Exxon station for $79,000. Habet did not inform the plaintiff about the contamination and the plaintiff did not conduct any investigation. When Mattingly applied to FBOL for a loan to finance the purchase of the station, the bank did not require a formal real estate appraisal because of the large down payment. Instead, it hired a real estate inspector to make an visual inspection of the property "to obtain an impression" of the property's value. The inspector was relatively new to the area but had some general knowledge about the contamination.

When the bank's loan committee met to act on Mattingly's loan application, both the FBOL president and the director who knew about the contamination raised the contamination issue. Two months after FBOL approved the initial loan request of $56,000, the plaintiff applied for a second loan in the amount of $127,000 to remodel and expand the service station. However, FBOL denied this loan request and Mattingly obtained an SBA-guaranteed loan of $105,000, using the proceeds to pay off the balance of his FBOL loan and to remodel the station.

Judgment for Bank Reversed. The plaintiff learned about the contamination in July 1991 when he tried to sell the property and the sale fell through after the prospective purchaser became aware of the contamination. One year later, the state Department of Health and Environmental Services notified the plaintiff that he was potentially liable for remediating the groundwater contamination. The plaintiff then sued Habet and also FBOL on the grounds of constructive fraud, negligence, and negligent misrepresentation. The trial court found Habet liable to the plaintiff for $435,000, but granted summary judgment to FBOL. The plaintiff then appealed to the Montana Supreme Court, which reversed the lower court ruling.

On the negligent misrepresentation count, the court found that the FBOL appraisal and approval of the loan constituted an affirmative representation that the property was worth at least the value of the loan. It said there was a material question of fact whether the plaintiff had relied on that representation.

On the question of constructive fraud, the court said that FBOL had peculiar knowledge of the contamination associated with the site that may have created a special duty to disclose that information to the plaintiff. Not only did FBOL fail to disclose the contamination to the plaintiff but it is possible, the court said, that a trier of fact could determine that FBOL created a false impression about the existence of the contamination by its words and conduct. Moreover, the court said, there was a question of material fact whether FBOL had gained an advantage by failing to disclose the existence of the contamination. In so ruling, the court observed that FBOL had taken back a mortgage from Habet that was paid off from the proceeds of the sale to the plaintiff. Finally, the court reinstated the plaintiff's claim for punitive damages since it was possible that a jury could find that FBOL was guilty of actual fraud or actual malice by failing to disclose what it knew about the environmental condition of the property.

While the facts of this case are somewhat unusual because of the manner in which the two members of the loan committee obtained information about the contaminated property, the case does provide an important lesson to lenders regarding environmental due diligence. Many lenders now routinely order environmental site assessments on property before approving a loan. This case shows how important it is for lenders to disclose what they know about the environmental conditions of a property not only to prospective borrowers but also to any other banks who may be contemplating purchasing all or part of a loan. Although many banks only want to review reports that are less than a year old, it is important that a lender planning to sell all or part of a loan review its files and provide the prospective purchaser with copies of all existing environmental reports in its possession since it is possible that there may be information contained in the older reports that was overlooked in the more recent report.

MidSouth Rail Corp. v. Citizens Bank & Trust Co.

The lender was more fortunate in *MidSouth Rail Corp.*[5] Here, MidSouth Rail Corp. had entered into a lease with Gulf Coast Sulphur Co. that allowed GCSP to build a sulfur processing plant along land bordering its railway line. GCSP soon ran into financial difficulties and began dumping raw sulfur at the site. It then obtained a $150,000 working capital loan from Citizens Bank and Trust Co. As collateral for the loan, CBT took back an assignment of the lease, personal guarantees, and liens on accounts receivable and inventory, including the raw sulfur.

GCSP continued to encounter financial difficulties, though. The primary shareholder and other stockholders then formed a new company, Gulf Coast Sulphur Corp. (GCS), which assumed the assets and liabilities of the old company. CBT extended a new $200,000 loan accommodation. The purpose of the loan was to refinance the old CBT loans and to pay off $50,000 in GCSP overdrafts. CBT apparently inspected the premises and knew the prior operation had a history of environmental violations liability but determined that the collateral value was sufficient.

In 1988, GCS filed for bankruptcy and abandoned the facility, leaving approximately 5,000 tons of sulfur on the ground. In 1989, the sulfur caught fire and destroyed the facility. The state Department of Environmental Quality responded to the emergency and ordered MidSouth to remediate the property. After incurring $160,000 in cleanup expenses, MidSouth sought reimbursement from CBT, who then filed a declaratory judgment to determine its liability. MidSouth filed a counterclaim that CBT was liable as the assignee of the lease and was liable for contribution under the state superfund law.

Because of perceived ambiguities in the lease assignment, the trial court took extensive testimony regarding the intent of the parties before dismissing MidSouth's lease claims. On the statutory contribution claim, however, the court found that CBT could be liable for contribution because the Mississippi mini-superfund law imposed liability on "any person creating, or responsible for creating . . . an immediate necessity for remedial or cleanup actions." The court found that CBT had consciously and purposefully allowed the GCS to continue running an operation that created the "immediate

[5] 697 So. 2d 451, 12 TXLR 404 (Miss SupCt 1997).

  TXLR 0887-7394/98/$0+$1.00

necessity for remedial action" and that the CBT's motive was to ensure that its old loan was paid off. Because CBT was "responsible for" enabling another to create an immediate necessity for cleanup, the court found the bank liable for ten percent of the remedial costs at the site.

Lender Prevails on Close Call. On appeal, the Mississippi Supreme Court in a 2-1 decision ruled for the lender on both claims. On the contract claim, the court noted that while the general rule is that contract assignees do not normally incur lease obligations in the absence of an express promise to do so, an assignee can be charged with obligations or covenants that run with the land. In this case, the lease required the lessee/assignor to comply with environmental laws. While the court found that the language in the assignment was broad and could be read to transfer the lease obligations to CBT, it ruled that the testimony introduced at trial court showed that the parties' intent was that the assignment be simply a collateral assignment to protect CBT's security interest. Another factor influencing the court was that CBT paid no rent to MidSouth and did not take possession of the property.

On the statutory contribution claim, the supreme court held the statute was penal in nature and had to be construed narrowly. Moreover, the court said, the trial court's broad interpretation would expose innocent lenders to suit simply for providing capital to a company that caused environmental harm.

MidSouth Rail was an extremely close call for the lender. In many other states, there could have been broad ramifications. A number of state mini-superfunds define liable parties to be persons who are "responsible" for the discharge. In these states, a party such as a lender that does not fall within one of the traditional four categories of potentially responsible parties[6] may still be liable as a "responsible party" under a state environmental law. More importantly, the case should be a warning to lenders and their counsel to take a careful look at their standard lease assignments forms and insert express language that the lender has no environmental obligations under the lease. This is especially important when the underlying lease has covenants requiring the lessee and its assignees to comply with environmental laws.

Given the poorly drafted assignment and the environmental covenants in the lease, it is quite likely that the court would have ruled against the bank had it exercised control of the property. Thus, this case should also send a strong signal to lenders to carefully review their procedures for taking possession of collateral and a borrower's facility following default.

[6] The four classes of PRPs include past and current owners of "facilities" and "vessels" (i.e., tanks, equipment, etc., in which hazardous substances have come to be located), past and current operators of facilities and vessels, generators of hazardous substances and transporters of hazardous substances. Under CERCLA, the definition of "owner or operator" contains an exclusion which states that any person who "holds indicia of ownership primarily to protect his security interest" in a vessel or facility will not be liable as an owner or operator if that person does not "participate in the management" of the facility or vessel.

FP Woll & Co. v. Fifth and Mitchell Street Corp.

This fact pattern illustrates the dangers that lenders face when they repossess collateral and exercise control over a facility to effectuate the sale of that collateral.[7] The case also shows how difficult it can be procedurally for a lender to remove itself from a case even when the lender may have complied with all the safe-haven requirements of CERCLA and the state lender liability law.

Eaton Laboratories Inc. leased a laundry and dry cleaning compound manufacturing facility. In December 1985, Philadelphia National Bank (PNB) declared Eaton in default of its loan. PNB foreclosed on Eaton's assets, including the inventory of hazardous substances located on the property, and promptly sold them to D.C. Filter and Chemical, which was also named a defendant. The current landowner filed suit seeking to hold PNB and others liable for the contamination at the site. The plaintiff asserted that PNB was liable as a facility "operator" because it took actions that constituted "active management" at the site. PNB then filed a motion to dismiss arguing that it was not liable because it met the safe-haven requirements of both the Lender Liability Amendments and the Pennsylvania Economic Development Agency, Fiduciary and Lender Environmental Protection Act of 1995. [8]

Under the Federal Rules of Civil Procedure, a court is required to accept as true all allegations in a complaint and may not dismiss any count unless it appears beyond doubt that the plaintiff cannot prove facts sufficient to support its claim. The court found that the complaint contained sufficient allegations which could not be disregarded without additional facts that would have to be developed later in the case. Accordingly, PNB's motion was dismissed. While PNB may ultimately prevail on the merits, it will have to incur the costs of additional litigation to establish the necessary factual background before it can dismissed from a case.

Practice Pointers for Auctions. As with *MidSouth Rail*, *F.P. Woll* shows that lenders must proceed with great caution and perform a detailed site inspection before foreclosing on the assets of a defaulted borrower. Many lenders that have taken control of a site after a borrower has gone out of business have received administrative cleanup orders and been required to remove hazardous substances and perform a remediation. Often times, the bank takes control of the facility in order to sell off the borrower's personal property in accordance with its lien. Typically, the bank does not take title to the property but simply hires an auctioneer to conduct the sale of inventory, fixtures, and equipment. Usually, there are barrels or drums of hazardous waste strewn about the facility and underground storage tanks as well. In order to avoid any suggestion that the bank or the auctioneer had any control over these hazardous wastes, the auctioneer often will rope off the area where the drums or barrels are found. In some cases, however, bidders are allowed to cherry-pick barrels containing useful raw materials. After the auction

[7] No. A 96-5973, 1997 WL 535936, 12 TXLR 454 (DC EPa 1997).

[8] 35 Pa. Stat. Ann. § 6027.1-6027.14.

is conducted, the drums and barrels are then left in the abandoned facility, eventually to be discovered by government authorities.

By taking control of the site, a lender may also unwittingly be asserting control over the USTs and expose itself to a claim by the landlord. This is a risk especially when there are environmental covenants imposing obligations on the borrower and when the lease gives the borrower the right to use or control the USTs.

To avoid these results, financial institutions should consult with environmental counsel prior to taking possession of a defaulting borrower's facility or conducting any auction at a manufacturing site. An environmental consultant or environmental attorney should be retained to inspect the facility to evaluate any cleanup liabilities that could result from conducting an auction. The lender should have its counsel review both the lease and the state UST registrations to determine who is responsible for the tanks. If the USTs are registered in the name of the borrower, it should discuss the status of the USTs with the landlord. If the landowner believes the USTs enhance the site's marketability, the lender may be in a good position to negotiate a satisfactory resolution to the UST issue prior to assuming control of the site for an auction of the borrower's assets.

Hiring Guards. Another practice that can expose a lender to liability is hiring guards. Often times, lenders conclude a guard is needed to protect inventory or equipment until the auction is conducted. More times than not, the guard is posted at the entrance to the plant and will not allow access to the property without the lender's approval. There have been a number of reported instances when a 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 the facility, the lender could be deemed to be an operator of the facility and be held responsible for remediating environmental problems at the site. To minimize this possibility, the guard should be posted in or outside the building where the collateral is located instead of at the gate leading to the facility.

The lender may also want an environmental consultant present at the auction to make sure that any hazardous substances remaining at the property are not disturbed or spilled. If such materials are inadvertently spilled, the consultant could take immediate steps to contain and clean up the spill and document those actions.

Over two dozen states have enacted their own lender liability statutes or promulgated lender liability regulations that can vary from federal requirements. Thus, in order to minimize any potential liability, lenders should also review the specific requirements of state laws or regulations before taking possession of their collateral.