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PITFALLS IN THE EPA'S LENDER LIABILITY RULE

A Proposed Rule Expands a Secured Lender's Ability to Protect its Collateral Without Incurring Liability for a Borrower's Environmental Cleanup Costs. Lenders Who Take Possession through Foreclosure Have a Twelve-Month Safe Harbor if They Actively Pursue Liquidation or Sale.

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After nearly a year of bureaucratic intrigue, the federal Environmental Protection Agency ("EPA") finally published its proposed lender liability rule on June 24th. The proposed rule sets forth EPA's interpretation of the secured creditor's exemption contained in the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA")[1] and while it must undergo a public comment period before it is formally codified, it is effective immediately as a guidance document for the EPA's regional offices.

EPA first committed to promulgating a rule interpreting the secured creditor's exemption on August 2, 1990 in order to stave off legislation to amend the provision. The legislative action came in response to the decision in *United States v. Fleet Factors*,[2] in which the U.S. Court of Appeals for the Eleventh Circuit dramatically expanded the potential CERCLA liability of lenders. A draft proposed rule was circulated for inter-agency review in January, and was strongly criticized by the Treasury Department, the FDIC, and the Office of Management and Budget because it failed adequately to protect governmental entities who might come to own or possess contaminated properties or assets of failed businesses or lending institutions. A revised draft also proved unsatisfactory to these same agencies, and it was only after the White House intervened through the Vice-President's Council on Competitiveness that the rule was approved for publication in the federal register.

It is important to point out that the EPA's proposal is not binding on federal or state courts. While judges will tend to defer to an agency's interpretation of its own rule, they exhibit less deference when the issue is whether an agency has properly construed a statute, especially where the agency has not adopted a consistent position.[3] Indeed, if the judicial treatment of EPA's guidance document on the liability of parent and successor corporations is an example of how courts will construe the lender liability rule, lenders will still be subject to uncertainty over their potential liability under CERCLA. However, the proposed rule specifically provides that any plaintiff arguing that a secured creditor is

1. 42 U.S.C. 9601 et seq.
2. 901 F.2d 1550 (11th Cir. 1990).
3. *Chevron U.S.A. v. Natural Resource Defense Council*, 467 U.S. 837, 104 S. Ct. 2778, 81 L.Ed.2d 694 (1984).

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not entitled to the secured creditor's exemption has the burden of proof.[4]

LENDER LIABILITY UNDER CERCLA

CERCLA provides that owners and operators of a facility or vessel (e.g., equipment, containers) may be strictly and jointly liable for cleanup costs associated with discharges of hazardous substances. This liability extends to current owners and operators of a site as well as past owners and operators who were responsible for the release of the hazardous substances. CERCLA contains a provision that exempts from the definition of owner or operator a lender who, "without participating in the management of . . . a facility, holds indicia of ownership primarily to protect . . . a security interest in property contaminated with hazardous substances."[5] Under the cases interpreting this secured creditors exemption, lenders may lose their immunity for at least a portion of their borrowers' cleanup obligations if they (1) acquire title to the contaminated property through foreclosure and thereby "hold indicia of ownership," or (2) become so entangled in the day-to-day management of their borrowers' operations as to be deemed to be "participating in the management of a facility."

Thus far, four federal district courts and two appellate courts have examined the scope of the secured creditor's exemption, with the decisions generally falling into two lines of authority.

On the issue of whether a secured creditor loses its immunity when it forecloses on contaminated property, one view, espoused in *United States v. Mirabile*[6] and followed recently by *In re Bergsoe Metals,*[7] construes the exemption broadly and views the acquisition of title through foreclosure as merely incidental to protecting a security interest that should not subject a lender to CERCLA liability. The other line of cases, exemplified by *United States v. Maryland Bank and Trust Company (MBT)*[8] and *Guidice v. BFG Electroplating & Manufacturing Company, Inc.* (*Guidice*),[9] has adopted a narrow construction of the secured creditor's exemption, and holds that a lender will be liable if it forecloses on property, regardless of the motive or the length of time that it is in the chain of title.

On the issue that is most important to lenders—namely, what constitutes the kind of control that will be considered "participation in the management" of a facility—the cases have failed to establish precisely the boundary between prudent oversight of a borrower's operation and excessive entanglement in its daily affairs. The most onerous ruling to date on this issue was the recent *Fleet Factors* decision, in which the Eleventh Circuit dramatically broadened the liability that lenders may face under CERCLA by expanding the types of action that could constitute "participation in the management" of a facility. The court held that a lender could be liable if it merely had the ability to influence or control the operations of its borrower. In essence, the court seemed to create a new category of liable parties just for lenders, in which they can be liable even if they do not qualify as statutory owners or operators of the facility. As a result, the court found that Fleet's post-foreclosure actions were sufficient to expose it to liability under CERCLA.

Just two months after *Fleet Factors* was decided, the Ninth Circuit issued its *Bergsoe* opinion, which effectively rejected the *Fleet Factors* holding. The *Bergsoe* court ruled that a creditor must exercise actual management authority over a borrower before the lender will be stripped of its immunity from CERCLA liability, and that merely having the ability to control the borrower without exercising that authority would not be sufficient power to impose liability on a lender.

ANALYSIS OF THE LENDER LIABILITY RULE

The proposed rule does provide some comfort to financial institutions in that it expressly rejects the *Fleet Factors* holding that the mere ability to control a borrower's operations will expose a lender to liability. However, it falls far short of the safe harbor that lending institutions had been seeking.

4. 56 Fed. Reg. 28801 (June 24, 1991).
5. 42 U.S.C. 9601(20) (A).
6. 15 Envtl. L. Rep. (Envtl. L. Inst.) 20994 (E.D. Pa., No. 84-2280, Sept. 4, 1985).
7. 910 F.2d 668 (9th Cir. 1990).
8. 632 F.Supp. 573 (D. Md. 1986).
9. No. 86-2093 (W.D. Pa., Sept. 1, 1989).

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Definition of Security Interest

The basic thrust of the secured creditor's exemption is to insulate from CERCLA liability creditors with indicia of ownership who take action primarily to protect a security interest in real or personal property. Hence, the starting point in the rule is what types of "indicia of ownership" fall within the definition of security interest.

The proposal states that a security interest is a transaction that provides recourse against real or personal property to secure payment or performance of some obligation or duty.[10] The proposed rule contains a list of transactions that normally qualify as security interests, including liens, trust receipt transactions, certain assignments, factoring agreements, accounts receivable financing arrangements, and some forms of lease or consignment. EPA also suggests that sale-leaseback transactions and conditional or installment sale agreements may also create security interests that fall within the exemption, but these transactions would have to be examined on case by case basis. Many financing arrangements are structured so that lenders are named as lessors of the property when in reality they are acting as security holders. Indeed, leasing is one of the most important financing devices available to businesses. The rule probably needs to clarify that certain kinds of lease arrangements, such as those in which the lender/lessor does not have maintenance control of the property, should fall within the exemption.

The proposal states that merely labeling a transaction as a security interest will not in itself bring the transaction within the exemption. If the interest is held primarily as an investment rather than to ensure repayment of a loan or the performance of some other obligation, the exemption will not apply to that interest holder. However, the EPA recognized that lending institutions have revenue interests in their loans, and 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 interest is to secure repayment of a loan or performance of some obligation. Lenders may restructure a loan when a borrower is encountering financial difficulties so that the bank will be entitled to shares in the increased value of the property or increased profits, depending upon certain events. When these actions are taken to recoup loan losses, it is unclear if EPA would view the bank as having primarily an investment interest in the property as opposed to a bona fide security interest.

Likewise, the rule also provides that the exemption will not apply to a financial institution acting in a non-lending capacity, such as a fiduciary, because the lender does not have a bona fide security interest in the real or personal property.

Loan Origination Activities

Many lenders now routinely require prospective borrowers to perform environmental audits prior to closing a loan, and to insert loan covenants or warranties requiring compliance with environmental laws. In addition, lenders may provide financial advice and other guidance to prospective borrowers regarding the structure and terms of the loan. The proposed rule states that these pre-loan actions will not be considered evidence of "participating in the management of a facility" that could cause a lender to be stripped of its immunity from liability.[11]

The EPA also states that CERCLA does not mandate that a lender must require or undertake an environmental audit in order to qualify for the exemption; nor may the creditor's liability be premised on its failure to undertake or require such an audit.[12] The rule also provides that where the risk of default is slight, a bona fide security holder may knowingly take a security interest in contaminated property without becoming subject to CERCLA liability. While the language of this provision may seem reassuring at first glance, it conflicts with CERCLA's innocent purchaser's defense, which allows landowners to raise a defense to liability only if they make an "appropriate inquiry" into the environmental conditions of the property. Given EPA's history of aggressively pursuing any owners who appear in the chain of title, it is unclear how a court will resolve this apparent conflict. Lenders should therefore proceed cautiously with waiving any environmental due diligence requirements, especially if the creditor intends to look to the collateral in the event of a default.

Permissible Activities During Loan Administration

The proposed rule broadly states that a lender may take actions during the life of a loan that are consistent with protecting its security interest without incurring liability. The proposal cautions, however, that a lender will cross the line into impermissible participation in the management of a facility when it either (1) exercises such decision-making control over the borrower's environmental compliance that the lender has assumed responsibility for the borrower's handling and disposal of hazardous substances, or (2) the

10. 56 Fed. Reg. 28802 (June 24, 1991).

11. Id. at 28803.

12. Id. at 28803–4.

lender assumes or manifests management-level control over the borrowers, such as by establishing, implementing, or maintaining policies and procedures concerning day-to-day environmental compliance.[13] The EPA does identify some actions that are consistent with protecting a security interest, including regularly or periodically monitoring a borrower's business, requiring or conducting on-site inspections or audits of the borrower's financial or environmental conditions, and enforcing environmental warranties or covenants.[14] To some extent, this provision of the rule represents a reversal of some of the grounds on which the federal government has argued in the past in its briefs to impose liability on lenders. However, the examples cited by the EPA do not advance the law or expand the immunity of lenders because the rule really only codifies practices that pre-*Fleet Factors* courts held were within the exemption.

Permissible Activities During Loan Workouts

When a borrower's business begins encountering problems, lenders increase their supervision and involvement over the borrower's operations, and will often negotiate workout agreements that give them broad management powers over the business. Lenders have been concerned that such actions will be construed as participating in the management of a facility, which would expose a creditor to CERCLA liability.

The proposed rule affirms that common workout practices such as providing financial advice or similar support to a distressed borrower or restructuring or renegotiating loan obligations (e.g., requiring additional interest payments or extending payment periods) will be considered actions taken to protect a security interest. Under the proposed rule, these actions will not take the security holder outside of the protection of the exemption so long as they are undertaken to help prevent a loan default or diminution of the value of the collateral, and the security holder does not divest the borrower of its decision-making authority.

This section contains a caveat that a security holder should be aware of the presence of hazardous substances on the property when providing advice or otherwise acting to protect its security interest to ensure that its own actions do not contribute to contamination and subject the lender to CERCLA liability.[15] This would suggest that lenders should still require or conduct an environmental audit before engaging in a workout. Furthermore, a lender will have to proceed with extreme caution when deciding whether to comply with the request of a distressed borrower for an over-advance to ensure compliance with environmental requirements.

Foreclosure

Lenders face their greatest exposure for CERCLA liability when they acquire title to contaminated property through a judicial foreclosure, exercise of a statutory power of sale, or acceptance of a deed in lieu of foreclosure. The proposed rule provides some relief to lenders by allowing them to take possession and foreclose on property in connection with a sale or liquidation of the borrower's assets for up to 12 months without incurring liability as an owner or operator of the property under CERCLA.[16] While this represents a major departure from the EPA's prior policy and litigation posture, there are some significant restrictions to this limited protection.

For example, the security holder must endeavor to divest itself of the property that it foreclosed upon or run the risk that it will be deemed in possession for some purpose other than to protect its security interest. To establish that the foreclosure is incidental to a sale or liquidation, a security holder must comply with a number of strict procedural requirements.

First, the security holder must begin advertising the property on at least a monthly basis in either a trade magazine, a real estate journal, or some other publication "suitable for the property in question," or in a general-circulation newspaper covering the area where the property is located. The EPA defines such a newspaper as one with a circulation over 10,000 or that local court rules deem sufficient for publication.[17]

In addition, six months after foreclosure, a secured creditor cannot reject or fail to act within 90 days of receipt of a written bona fide offer for fair consideration for the property. The EPA defines "fair consideration" to be an amount equal to or greater than the outstanding principal owed, plus any unpaid interest and penalties, and reasonable fees incurred by the security holder during the foreclosure period less any net revenues received by the security holder in continuing operations of the facility or in connection with any partial disposition of the property. Where a lender rejects, outbids, or fails to act on an offer of fair consideration, the EPA will presume that the security holder is acting for some reason other than to protect its security interest.[18]

13. Id. at 28803.
14. Id. at 28804.
15. Id. at 28804–5.
16. Id. at 28805.
17. Id. at 28806.
18. Id. at 28805.

While a lender is attempting to dispose of the property, it may also wind up operations, liquidate or sell off assets, or otherwise act to recover the value of its security interest in a manner consistent with good commercial practice, without triggering liability.[19] The EPA says that "winding-up" operations include those actions necessary properly and responsibly to close down a facility, secure the site, and otherwise protect the value of the foreclosed asset for subsequent liquidation.

In addition, EPA will require the security holder to take affirmative steps to prevent or minimize the risk of releases or threatened releases of hazardous substances at the facility, such as the removal of drummed wastes. This requirement places lenders in a bind, because while such environmentally responsible actions will not be deemed to be participating in the management of the facility, the security holder could still find itself saddled with CERCLA liability as a generator or transporter of hazardous substances for wastes sent off-site. If the waste disposal facility where the wastes are sent must be cleaned up, the customers of the facility, including the security holder, could be liable for the cleanup. However, if the lender fails to take mitigative or environmentally responsible actions, it may lose its cloak of immunity for the foreclosed property.

EPA's proposal to allow a security holder to hold title for up to 12 months without being deemed to be an owner or operator under CERCLA arguably clashes with the requirements of the innocent purchaser's defense. Since this new interpretation represents a significant departure from prior EPA policy, it is unclear how a court will resolve this conflict in a private party action against a bank. In the absence of a consistent EPA policy, a court could choose to ignore EPA's interpretation and hold that the lender who cannot avail itself of the innocent purchaser's defense is liable under CERCLA as an owner of the property.

One remedy often exercised by lenders is to be appointed as a receiver, keeper, or conservator to manage the property of a troubled borrower. The rule needs to clarify whether this type of activity falls into the class of permissible activities that a security holder may undertake during a workout.

Likewise, another important remedy is for lenders to transfer properties to subsidiaries or affiliates when foreclosing or taking possession of property. It is unclear whether under the proposed rule the subsidiary or affiliate can be considered a successor in interest who will be eligible for the exemption. Furthermore, the proposal does not indicate whether a lender will lose its exemption by allowing its subsidiary or affiliate to take possession of or title to contaminated property.

The proposal also fails to indicate expressly whether a security holder who initially forecloses on a property, but then does not try to sell the property because it waives its rights or transfers its security interest back to the borrower, will still be able to assert the exemption.

Federal Lien

Finally, if EPA performs a cleanup of the foreclosed property, and a subsequent sale yields funds in excess of an amount that the security holder is entitled to under the rules of equity, the proposed rule states that EPA may seek equitable reimbursement for any amount by which the secured creditor has been "unjustly enriched," or for any increase in the property value as a result of the EPA cleanup.[20]

Miscellaneous Issues

In addition to the concerns previously discussed, the EPA proposal failed to address other issues that are of concern to the lending community.

Most of the CERCLA cases in which lenders have found themselves involved were brought by third parties such as landlords of borrowers or residents living adjacent to contaminated parcels. Unfortunately, the proposed rule does not directly address this issue. The EPA tried to circumvent it by proposing to incorporate the rule into the National Contingency Plan ("NCP"), which is the national blueprint for performing cleanups of oil spills and hazardous waste discharges. Under CERCLA, private parties may recover only cleanup costs that were incurred in accordance with the NCP requirements. Lenders have to hope that courts will prohibit private parties from suing banks that comply with the rule on the grounds that such a suit is inconsistent with the NCP. This is a rather slender reed upon which to pin a cloak of immunity, and it would appear that only legislation can resolve this issue.

Similarly, since EPA does not have the authority under CERCLA to pre-empt state laws, the proposal will not preclude state environmental authorities from filing suits against lenders under their state versions of CERCLA. Third parties may also not be barred from bringing such actions against lenders if a state Superfund law allows private

19. Id. at 28800.

20. Id. at 28806.

parties to bring their own contribution or cost-recovery actions.

Along the same lines, the proposal does not cut off liability that secured creditors may have under other federal environmental laws, such as the Resource Conservation and Recovery Act ("RCRA"),[21] which impose strict liability on owners and operators. The definition of "owner" appearing in the RCRA subchapter covering underground storage tanks contains a similar secured creditor exclusion. The number of properties potentially subject to cleanup under RCRA far exceeds those covered by CERCLA, and includes not only hazardous waste or industrial facilities but also gas stations, convenience stores, auto dealerships, fleet operators, and other businesses that contain underground storage tanks or that use common solvents, degreasers, thinners, dyes, and paints. The potential cleanup liability for these businesses could be substantial, but lenders foreclosing on such properties will not be able to avail themselves of the CERCLA secured creditor's exemption.

Finally, EPA also specifically declined to address the issue of the liability of lending institutions acting in a fiduciary capacity. Financial institutions often act in a variety of representative capacities such as trustees of living trusts, testamentary trusts, probate estate personal representatives, guardians or conservators of an estate, corporate trustees, retirement plan trustees, and bankruptcy, and the estates they administer or manage may contain real estate that could be contaminated with hazardous substances from previous operations. Often a bank trust department may not be advised of its appointment until just before the will is offered for probate, and therefore may not have time to undertake the "appropriate inquiry" required to raise the innocent purchaser's defense. While the bank may subsequently renounce its appointment after learning of an environmental problem, such action would not abrogate any potential liability that it may already have incurred as an owner or operator of the estate's contaminated property. Indeed, a federal court recently refused to dismiss from a private lawsuit seeking recovery of cleanup costs a bank that served as the trustee of a trust with a substantial ownership in a die-casting business that allegedly caused the contamination.[22] Without the cloak of the secured creditors exemption, a financial institution acting as fiduciary cannot be assured that it will not be liable as an owner or operator of the contaminated property.

Finally, the proposal implies but does not expressly state that it applies to existing security interests as well as those created after the effective date of the rule.

Unless EPA corrects these ambiguities or deficiencies in the final rule, lenders will continue to face uncertainty over their potential liability under CERCLA.■

21. 42 U.S.C. 6901 et seq.

22. *Quadion Corp. v. Mache*, No. 89-C-3536 (C.D. Ill., May 17, 1990).