Loan Officer's Legal Alert

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Environmental Liability

Recent Cases Highlight a Number of Important Areas in Lenders' Environmental Liability

By Lawrence P. Schnapf • Lord Day & Lord, Barrett Smith • New York

While the commercial lending community has focused its attention on the development, issuance, and implications of EPA's Final Rule on lender liability (see *LOLA*, August, September, and October 1992), a number of significant environmental liability cases have gone largely unnoticed. These cases continued to define the contours of lenders' environmental liability and have provided further guidance to financial institutions on the remedies they may employ to minimize such liability.

Financial institutions are primarily concerned with the federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), which imposes strict and joint liability on past and present owners or operators of facilities, as well as on generators and transporters of hazardous substances. CERCLA exempts from the definition of owners or operators any person who "without participating in the management of a...facility, holds indicia of

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ownership primarily to protect...a security interest in property contaminated with hazardous substances."

This provision is known as the secured lender's exemption, and cases have held that lenders may lose their immunity from liability for the cleanup of hazardous substances if the lenders (1) acquire title to contaminated property or (2) become so entangled in the day-to-day affairs of the borrower's operation that the lender is deemed to be "participating in the management of the facility." The Final Rule was intended to provide guidance to lenders on what constitutes "participation in the management of a facility," and it also specifies conditions under which lenders could foreclose on property without forfeiting their immunity from liability.

Two of the five recent cases discussed in this article involve the scope of lender liability under CERCLA, whereas two others deal with common law remedies available to lenders who have commenced foreclosure proceedings but are concerned about potential environmental liability. The final case discusses the rights of a lender to gain access to a borrower's property for the purpose of performing an environmental audit.

Lender Forces Borrower's Management Out

The most important case of this group is *Grantors to the Silresim Site Trust v. State Street Bank & Trust Co.*, No. 88-1324-K (D.C. Mass. 1992). In this case, the predecessor to the defendant, Union National Bank (UNB), held a mortgage and security interest in the equipment and inventory of the Silresim solvent reclamation facility located in Lowell, Massachusetts. When the borrower defaulted on its loan obligations, UNB conditioned future loan advances on the removal of the firm's president and chief financial officer and also insisted that Silresim retain a management consultant.

After the management consultant assumed control of the Silresim facility, the company ceased reclamation activities, and hazardous wastes began to accumulate and were ultimately released into the environment, causing massive soil and groundwater contamination. As a result, the facility was placed on the federal Superfund list and the company's customers were named as potentially responsible parties (PRPs), liable for an estimated $30 million to $50 million cleanup. These PRPs then filed suit against the bank, alleging that the bank exercised effective day-to-day control over the site and was, therefore, an operator of the facility for purposes of CERCLA liability.

The federal district court for the district of Massachusetts held that UNB's actions were consistent with protecting its security interest, and that UNB's removal of Silresim's president, and its placing an agent in charge of the operation, did not amount to "participation in the management of the facility."

Lewis Koflowitz, Editor James F. Slabe, Publisher

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A Remarkable Decision

This was a remarkable decision, because this set of facts resembled the circumstances in *U.S. v. Mirabile*, 15 Envtl. L. Rep. 20994 (E.D. Pa. 1985), in which similar involvement by a bank's loan officer prompted a federal district court to deny the bank's motion for summary judgment. Indeed, the plaintiffs' position seemed stronger in the *Silresim* case because, in view of the fact that the borrower's operation was a hazardous waste recycling facility, it would appear to be difficult for UNB to argue that its representative was not controlling hazardous waste activities. Furthermore, such active involvement in the operational aspects of a borrower would seem to expose UNB to liability under EPA's Final Rule.

The outcome in this case may have simply been a result of the strategy employed by the plaintiffs' attorneys. The plaintiffs originally tried to argue that the management consultant was an agent of UNB and that the bank was therefore participating in the management of the facility. However, in oral argument the plaintiffs focused on the ruling in *United States v. Fleet Factors*, 901 F.2d 1550 (11th Cir. 1990), which held that a financial institution could be held liable if it had the mere *ability* to control hazardous waste operations. It appeared that the court found this theory of liability troubling, and this line of argument seemed to distract the court from focusing on the relationship between the bank and the management consultant.

Limitation of the Final Rule

The limitation of the lender liability rule was highlighted in *U.S. v. A & N Cleaners and Launderers, Inc.*, 788 F. Supp. 1317 (S.D.N.Y. 1992), in which a lender was held liable for the environmental obligations of its sublessee. In this case, Marine Midland Bank maintained a branch location in a one-story brick office building in Buffalo, New York, under a triple net lease. Marine Midland was obligated to maintain fire, casualty, and liability insurance, and to maintain the property in good condition. However, Marine Midland was also allowed to alter the building, change the grade, and erect improvements, and was given the unconditional right to sublet the premises so long as the bank collected the rents and enforced the lease covenants.

Shortly after the bank occupied a portion of the building, the building owner assigned all of the leaseholds in the building, including the lease of a dry cleaning establishment. During the ensuing thirteen years, Marine Midland collected rent and negotiated a number of lease extensions with the dry cleaner and its subtenant. As it turned out, the dry cleaning operation routinely discharged trichloroethylene (TCE) into a dry well, which contaminated the groundwater.

The federal district court in New York ruled that the bank exercised such control over the site that it was essentially the owner of the property and was therefore liable under CERCLA. This case reaffirms that the lender liability rule only protects financial institutions while they are acting to protect a security interest, and will not insulate a lender if there is a separate basis to find it liable as an owner or operator of a facility.

The obvious lesson to learn from this case is that a lender should perform environmental due diligence prior to exercising any of its rights.

One aspect of the ruling was particularly interesting. The plaintiffs argued that the secured creditor's exemption raised by UNB to avoid liability was an affirmative defense and that the bank had the burden of proving that it was entitled to the defense. The court ruled, however, that the bank was simply pleading that it was not a liable party, and that the burden was on the plaintiffs to establish that the bank was not eligible for the secured creditor's exemption.

Importance of Due Diligence and RCRA Liability

The importance of performing due diligence and of considering common law principles prior to foreclosure were highlighted in *Hawkeye Land Co. v. Laurens State Bank*, 480 N.W.2d 854 (Iowa 1992). In that case, Leo Koenig operated a bulk petroleum storage facility under a lease with the plaintiff, and had also been granted a security interest in the leasehold improvements on the site.

When Koenig defaulted on his lease, Hawkeye Land Co. (the plaintiff/property owner) terminated the lease and ordered Koenig to remove the storage tanks and improvements on the property as required by the lease. By that time, Koenig had also defaulted on a loan obligation with Laurens State Bank, and when the bank threatened to foreclose, 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 security interest in the storage tanks and improvements and he was no longer responsible for removing these structures.

When the plaintiff was unable to sell the property because of the presence of underground storage tanks, Hawkeye received an offer from a salvage company and requested that the bank relinquish its claim to the structures. The bank refused and also declined Hawkeye's request to remove the tanks. When a buyer for the property was found, the bank insisted that $1,500 of the $3,500 sale price be paid to it in exchange for its release of its interest in the improvements. When the sale fell through, the plaintiff filed suit against the bank, seeking injunctive relief ordering the bank to remove the storage tanks.

In its defense, the bank 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 the bank, the Iowa Supreme Court ruled that the bank had exercised sufficient control over the storage to be deemed the owner of the improvements and that the tanks' continued unwanted presence amounted to a trespass. Therefore, the court ordered the bank to remove the storage tanks.

This case demonstrates another limitation in the EPA Final Rule, which was issued two weeks after this decision. Even if EPA had issued the rule earlier, the bank could not have raised the rule as a defense because the tank closure requirements, with which the bank was ordered to comply, stem from the federal Resource Conservation and Recovery Act (RCRA), whereas the lender liability rule only addresses liability under CERCLA. Properties potentially subject to cleanup under RCRA far exceed those covered by CERCLA, and may include gas stations, convenience stores, auto dealerships, fleet operators, dry cleaners, or other businesses that may use underground tanks to store hazardous chemicals, fuel, solvents, degreasers, thinners, dyes, or paints.

Timing of Due Diligence

The timing of environmental due diligence was a critical factor in *Chase Lincoln Bank v. Kesselring-Dixon,* 554 N.Y.S. 2d 379 (1990), in which a bank unsuccessfully sought to undo a judgment of foreclosure on property that turned out to be contaminated with hazardous substances. After obtaining the judgment of foreclosure and sale, the plaintiff bank did not immediately proceed to foreclosure. Instead, it conducted an environmental audit that 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 judgment fifteen months after it was granted and sought to recover the debt from the borrower's principals.

It may also be advisable to specifically allow for the performance of environmental audits.

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 thus a site inspection would have alerted the bank to the potential contamination. Because 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 to learn from this case is that a lender should perform environmental due diligence prior to exercising any of its rights.

Gaining Access to a Site

Gaining access to a site to perform an environmental audit can be a problem at times, especially when a borrower has defaulted. In *Resolution Trust Corp. v. Polmar Realty, Inc.,* 780 F. Supp. 177 (S.D.N.Y.), a federal district court in New York ruled that, because of the importance of environmental due diligence, a lending institution could obtain injunctive relief ordering a borrower to provide access to the site to enable the lender to perform a Phase II environmental audit. Although the court found that the plaintiff would suffer irreparable harm if it was not allowed to investigate the site, the key factor was that the mortgage provided the lender with the right of entry and immediate possession of the property.

The borrower argued that the right of entry was a standard mortgage 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 the physical control of the property and that a Phase II audit fell within that broad authority. However, the court imposed conditions on the lender to make sure that the audit limited disruption of the borrower's busi-

ness as much as possible, that the test be done carefully and in accordance with law, and that the lender provide insurance against damage resulting from the testing.

Based on the holding in this case, lenders would be well-advised to review their loan documents to assure that there are provisions that provide them with a right of entry. It may also be advisable to specifically allow for the performance of environmental audits.

Lawrence P. Schnapf is a senior associate in the Environmental Practice Group at Lord Day & Lord, Barrett Smith, and is the author of Environmental Liability: Law and Strategy for Businesses and Corporations, *published by Butterworths Publishers.*

Origination & Documentation

Lender Lost Perfected Interest in Equipment by Filing Continuation Statement Two Days Early

A secured lender can just as easily lose a perfected interest in collateral by filing a continuation statement too early as by filing too late. That point was made clear by a recent decision from the Kentucky Court of Appeals.

In *Banque Worms v. Davis Construction Co.*, Banque Worms, a New York bank, lent $11.75 million to Dollar Branch Coal Corp. and Big Oak Coal Co., two Kentucky coal mining companies. As security for the debt, the companies executed a security agreement in favor of the bank that covered certain mining equipment, including a Euclid R-25 rock truck. On October 12, 1982, the bank perfected its security interest in the vehicle for a five-year period by filing a financing statement with the Harlan County Clerk. On April 10, 1987, the bank filed a continuation statement with the clerk that sought to extend the effective period of its financing statement for an additional five years.

The trial court decided that the bank's security interest in the truck was unperfected on the date it was transferred to Davis because the bank had filed the continuation statement prematurely . . .

On November 23, 1987, without the bank's consent, Dollar Branch and Big Oak sold the rock truck to Davis Construction Co. in satisfaction of a $36,200 debt. After acquiring a bill of sale for the truck and learning of the bank's interest in it, Davis filed an action seeking a judgment that it had a clear title to the vehicle. The trial court decided that the bank's security interest in the truck was unperfected on the date it was transferred to Davis because the bank had filed the continuation statement prematurely, and thus Davis had acquired clear title to the vehicle. The bank appealed to the Kentucky Court of Appeals.

Premature Filing Causes Loss of Perfection

In the appeal, the bank first argued that the lower court had erred in finding that the bank's security interest in the truck was unperfected on the date the truck was transferred to Davis. The appeals court disagreed.

The court noted that UCC Section 9-404(3) provides, in effect, that if a security agreement that retains a security interest in collateral has been perfected by the filing of a financing statement, the statement lapses at the expiration of a five-year period, unless a continuation statement is timely filed prior to the lapse. To be timely, a continuation statement must be filed within six months prior to the expiration of the five-year period during which the original financing statement is effective.

It was undisputed that the bank's continuation statement was filed six months and two days before the expiration of the financing statement's five-year effective period—that is, two days prematurely. Because of the premature filing, the appeals court found that the bank's security interest in the rock truck became unperfected on October 12, 1987.

The bank argued, however, that Kentucky UCC Section 1-102 required the court to construe the code liberally and in a manner that promotes the Code's underlying policies and purposes, including those of protecting secured creditors from unauthorized