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# LENDER LIABILITY UNDER CERCLA: AN UPDATE

*Recent Decisions Exempt Lenders Who Actively Participate in a Borrower's Workout Activities, But Impose Liability For Holding Title as Trustee or Managing Property as a Sublessor. The First CERCLA Case To Go to Judgment Exonerated the Defendant Despite the Replacement of the Borrower's President and CFO by the Lender's Management Consultant.*

Larry Schnapf*

Did the federal Environmental Protection Agency's lender liability regulations[1] make the world (or at least the United States) safer for banks? The results of a recent cluster of federal court decisions suggest that while the EPA regulations have provided a safer harbor for lending institutions, there are still treacherous shoals that banks must navigate to escape liability under the federal Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA").[2]

## LENDER LIABILITY UNDER CERCLA

CERCLA 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 owner or operator any person 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."[3]

This provision is known as the secured lender's exemption, and the courts 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 lenders are deemed to be "participating in the management of the facility."

The EPA lender liability rule was intended to provide guidance to lenders on what constituted "participation in the management of a facility," and also to specified conditions under which lenders could foreclose on property without forfeiting their immunity from liability.

1. 40 C.F.R. 300.1100.
2. 42 U.S.C. 9601 et seq.
3. 42 U.S.C. 9601(20)(A).

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## FORECLOSING LENDERS

In *Ashland Oil v. Sonford Products Corporation*,[4] the federal court for the District of Minnesota ruled that a financial institution that had taken title to its borrower's assets fell within the protection of the lender liability rule because the lender had foreclosed to protect its security interest and had complied with the rule's foreclosure requirements.

In that case, Ashland Oil, Inc. ("Ashland") leased a facility to a manufacturer of wood preservatives, Sonford Products Corporation ("Sonford"). Industry Financial Corporation ("IFC") entered into a financing arrangement with Sonford in which IFC took back a security interest in certain personal property of Sonford, including inventory and equipment. When Sonford filed for bankruptcy, IFC acquired title to Sonford's assets as part of a bankruptcy transaction for a period of three to four weeks before the assets were transferred to another entity, Park Penta ("Penta"). IFC retained a security interest in the assets that were conveyed. Within a year, Part Penta also filed for bankruptcy, and IFC abandoned its security interest in the assets. After Ashland discovered that the property had been contaminated from leaking barrels and equipment, Ashland sought to hold IFC liable under CERCLA for the cleanup of the facility under a variety of theories.

First, Ashland argued that IFC was liable as the owner or operator of the leaking vessels. However, the court ruled that IFC had complied with the EPA's requirements that a foreclosing lender must take steps to sell property expeditiously within 12 months, and, therefore, could not be liable as a CERCLA owner or operator.

In addition, Ashland contended that IFC was liable as a generator of hazardous substances by having acquired title to contaminated materials and then selling these materials to Penta. However, the court found that extending generator liability to sales of land containing hazardous substances would be a strained interpretation of CERCLA. For IFC to be held liable, the court explained, it must have been actively involved in decisions regarding the disposal of hazardous substances.[5]

An interesting aspect of this case was that the court did not rule that the mere filing of Ashland's private contribution action was prohibited by the EPA lender liability rule. During the public comment period, bankers asked that the rule expressly prohibit private actions. The EPA responded that it was placing the rule within the National Contingency Plan ("NCP"), which is the set of federal regulations governing cleanups. Since private parties may only recover cleanup costs that are incurred consistent with the NCP, the EPA argued that placing the rule within the NCP would automatically strip courts of jurisdiction to hear private CERCLA actions against banks. Many commentators questioned the effectiveness of this strategy.[6] Indeed, by considering the merits of Ashland's action, the court demonstrated that banks will remain exposed to cost recovery or contribution suits by private parties.

## WORKOUT ACTIVITIES

In another favorable ruling, a federal district court in *Kelley v. Tiscornia and Manufacturers National Bank of Detroit*[7] refused to impose liability on a bank that kept an exceedingly tight rein over its borrower during a workout, because the lender's actions were protected by the EPA lender liability rule. This was a significant decision that will give great relief to the lending community since financial institutions have been held liable in the past on similar sets of facts. In this case, the state of Michigan sought to recover from Michigan National Bank ("MNB") response costs incurred at the Auto Specialties Manufacturing company ("AUSCO"). MNB entered into a number of financial arrangements with AUSCO between 1964 and 1988, and

4. 810 F.Supp. 1057 (D. Minn. 1993).

5. Ashland also argued that IFC had participated in the management of the facility by reviewing Sonford's finances, but the court held that this was simply financial oversight that was permissible under the lender liability rule.
6. See B&SF, Vol. 8, No. 12 (June 24, 1992).
7. 810 F.Supp. 901 (W.D. Mich. 1993).

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Michigan argued that MNB had participated in the management of the AUSCO site during this period, and was therefore liable as a CERCLA owner/operator.

In its motion for summary judgment, Michigan asserted that the following actions by MNB constituted participation in the management of the AUSCO facility:

(1) An officer of MNB sat on the AUSCO board from 1964 to 1986;

(2) Between 1985 and 1988, MNB monitored AUSCO's cash flow on a daily basis, prohibited outside financing, and banned dividends;

(3) In 1986 MNB threatened to terminate its financial relationship with AUSCO unless the company terminated its CEO and CFO, and hired a turnaround specialist, Benjamin Sachs, recommended by MNB, as President and CFO;

(4) AUSCO officers were told by MNG that it would terminate its relationship if the company did not accede to Sachs's bonus demands;

(5) MNB representatives and Sachs met weekly to discuss the company's operations;

(6) Minutes of executive committee meetings indicated that Sachs had cleared expenditures for relocating the company's offices with MNB; and

(7) An MNB loan officer told AUSCO officers that he had authorized Sachs to fire them.

Relying on caselaw decided under the doctrine of equitable subordination, the court found that none of these actions created the inference that MNB had exercised the kind of operational control over AUSCO that would impose CERCLA liability under the EPA lender liability rule. Instead, the court held that MNB was simply exercising prudent financial oversight. For example, the court found that the presence of the MNB officers on the board of directors did not establish that MNB was exercising operational control since the board met only twice a year to deal with pension and capital spending. It was the executive committee, the court explained, that was responsible for operational issues and environmental compliance.

The court also found that neither the close monitoring of AUSCO nor MNB's conditioning of continued financing on the implementation of certain business plans constituted the impermissible control required for CERCLA liability. The court found that these actions were necessary for MNB to protect its security interest and that while MNB may have exerted influence over AUSCO, influence alone did not trigger CERCLA liability.

As for the actions of Benjamin Sachs, the court acknowledged that MNB exerted substantial influence over him on financial matters, but that there was no evidence that the bank exercised operational control: The court found that even the threats of the MNB employee to fire certain officers did not rise to operational control. The court said that it was not sure if the bank had such management control and would not find liability on an "Al Haig theory of power." Even if the bank had such authority, the court said, these were actions generally taken by personnel managers. Since the EPA lender liability rule considered personnel matters to be administrative functions, such authority fell within the exemption.

On the facts of this case, the court could have ruled in either direction and it would appear that it was not sympathetic to imposing CERCLA liability on banks. The court said that imposing such liability would increase the number of abandoned hazardous waste sites because banks would refuse to extend credit to troubled borrowers and might even call loans rather than nursing financially ailing borrowers back to health, if such actions might expose the banks to liability.

This case illustrates the lengths to which some courts will go to protect lenders from CERCLA liability. Under the reasoning of this court, a lender will be liable under CERCLA for participating in the management of a facility only if it actually operates the assembly line or personally tosses hazardous waste drums into the backyard. However, until other jurisdictions endorse the view of the MNB court, bankers should continue to proceed cautiously during workouts.

The *Ashland* and *Tiscornia* cases are also significant in that they demonstrate that the EPA lender liability rule will be applied retroactively to transactions that took place prior to its April 29, 1992 effective date.

## *BANKS/TRUSTEES*

In a ruling that is likely to send shudders through the trust departments of many financial institutions, a federal district court ruled in *City of Phoenix v. Garbage Services Co.*[8] that a bank that held title as trustee to a landfill would be liable as owner for its cleanup costs.

8. No. C 89-1709 SC (D. Ariz., Jan. 19, 1993).

In this case, Wilbur Estes conveyed a landfill in 1965 to two individuals, but retained an option to repurchase it. Shortly thereafter Estes died, and Valley National Bank ("VNB") was appointed executor of the Estes estate. Estes's will also established a testamentary trust that conveyed the balance of his property to VNB as trustee.

VNB subsequently exercised the option to repurchase the landfill in 1966, and the warranty deed conveyed the property to VNB "as trustee." At the time of the conveyance, the landfill was leased and operated by Garbage Services Company ("GSC"). VNB continued this arrangement, paid property taxes and also obtained liability insurance for the landfill.

After the landfill ceased operating, the city of Phoenix commenced condemnation proceedings. During this proceeding, VNB's ownership was contested by Mary Rose Estes but VNB was found to be the sole record owner of the site. When Phoenix sought to recover from VNB the cleanup costs it had incurred to remediate contamination from hazardous substances that had been disposed at the landfill, VNB moved for summary judgment that it was neither an owner nor an operator of the landfill.

The court agreed that VNB was not an operator of the landfill because the bank was not involved in its day-to-day administration. The court also noted that VNB did not know the identity of GSC's customers and that its communications with VNB were limited to tax matters involving the estate and did not include the operation of the landfill.

However, the court found that VNB was the owner of the landfill. The court held that Congress intended the term "owner" to have the broadest possible meaning, and therefore, under trust law, a trustee holding legal title could be liable as an owner of the land for obligations flowing from the land. Thus, the court ruled that CERCLA owners included trustees who held legal title.

In so holding, the court essentially found that a trustee could be personally liable for a trust estate. However, this would appear to be inconsistent with the Uniform Probate Code or Uniform Trust Act which limit a trustee's personal liability for torts arising out of ownership to situations in which the trustee was at fault. Since the court ruled that the trustee was not an operator, the trustee's liability would be predicated simply on its status as an owner and not on any wrongful or tortious conduct. This ruling would also seem to fly in the face of the provisions of the Restatement of Torts[9] and trust law,[10] which provide that a trustee is entitled to indemnity from the trust estate absent wrongful conduct. The decision would also appear to contradict two federal district court rulings from Illinois decided a few months earlier in which trustees who merely held title were found not to be CERCLA owners.[11]

VNB argued that the lender liability rule insulated it from liability but the court held that the rule applied only to lenders acting in their role as secured creditors, and was not controlling when a bank held bare title as a trustee.

To buttress its holding further, the court pointed to PRP letters that the EPA had sent to trustees in other CERCLA actions as evidence that the EPA also agreed that trustees could be liable as owners. The court rationalized that it had to defer to the EPA's interpretation of the statute. However, in so doing, the court ignored the EPA's comments in the preamble to the lender liability rule in which the agency said that while a trust's assets may be liable for a cleanup, the agency knew of no case in which a trustee could be personally liable solely because trust assets were contaminated.

During the public comment period preceding the adoption of the lender liability rule, the lending industry vigorously pressed to have the rule extended to fiduciaries and trustees. However, the EPA indicated that it found no colorable basis for construing the secured creditor's exemption to cover instances in which financial institutions hold title as trustees and not simply to protect their security interest.[12]

This case demonstrates the limited protection of the lender liability rule. Financial institutions often act in a variety of representative capacities, such as the trustees of living and testamentary trusts, probate estate personal representatives, guardians or conservators of an estate, corporate trustees, retirement plan trustees and bankruptcy trustees. The estate they administer or manage may contain real estate that could be contaminated with hazardous substances from prior 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 be able subsequently to

9. 265 Restatement of Torts (Second).

10. 111A Scott or Trusts 3244 (1988).
11. *Premium Plastics, Inc. v. LaSalle National Bank*, No. 92-C413 (N.D. Ill., Oct. 22, 1992); *U.S. v. Petersen Sand and Gravel, Inc.*, 806 F.Supp. 1346 (N.D. Ill. 1992).
12. 57 Fed. Reg. 18349 (Apr. 29, 1992).

renounce its appointment after learning of an environmental problem, such an action would not abrogate any potential liability that it may already have incurred as an owner or operator of the estate's contaminated property. It remains to be seen whether the *City of Phoenix* case will have the same effect as the *Fleet Factors* case, and will serve as a rallying point around which lenders may be able to apply pressure on the EPA or Congress to extend the cloak of protection afforded by the lender liability rule to banks acting as trustees or fiduciaries.

## LENDERS/SUBLESSORS

The limitation of the lender liability rule was highlighted in *United States v. A & N Cleaners and Launderers, Inc.*,[13] 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 under a triple net lease. Marine was obligated to maintain fire, casualty, and liability insurance, and to maintain the property in good condition. However, Marine was also allowed to alter the building, change the grade and erect improvements, and was given the unconditional right to sublet the premises as long as the bank collected the rents and enforced the lease covenants.

Shortly after occupying a portion of the building, the owner assigned all of the leaseholds in the building, including the lease of a dry cleaning establishment. During the ensuing 13 years, Marine collected rent and negotiated a number of lease extensions with the dry cleaner and its subtenant. It turned out that the dry cleaning operation was routinely discharging TCE into a dry well that contaminated the groundwater.

The court 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 for finding it liable as an owner or operator of a facility.

## FIRST LENDER LIABILITY CASE TO GO TO JUDGMENT

In the first decision to proceed to final judgment, a bank was found not liable as an owner or operator of its borrower's facility. In *Grantors to the Silresim Site Trust v. State Street Bank & Trust Co.*,[14] 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 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 Silresim, 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 PRPs liable for an estimated $30 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."

This decision was remarkable in that this set of facts resembled the circumstances in *United States v. Mirabile*,[15] in which a similar involvement by a bank's loan officer prompted a federal district court to deny the bank's motion for summary judgment. Indeed, the plaintiff's position seemed stronger in this case. Because the borrower's operations was a hazardous waste recycling facility, it would appear 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 the EPA lender liability rule.

The outcome in this case may simply have been a result of the strategy employed by the plaintiff's 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, at oral argument the plaintiffs focused on the ruling in *United States v. Fleet Factors*,[16] which held that a financial institution could be held liable if it merely had

13. 788 F.Supp. 1317 (SDNY 1992).

14. No. 88-1324-K (D.C. Mass., Sept. 21, 1988).
15. 15 Envtl. L. Rep. 20994 (E.D. Pa. 1985).
16. 901 F.2d 1550 (11th Cir. 1990).

the 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 it from focusing on the relationship between the bank and the management consultant.

One aspect of the ruling was particularly interesting. The plaintiffs argued that the secured creditor's exemption that UNB invoked 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.

## COMMON LAW

A handful of cases were decided while the lender liability rule was being promulgated. These largely unnoticed cases continued to define the contours of lenders' environmental liability, and also provide further guidance to financial institutions on the remedies they may employ to minimize their environmental liability.

The importance of performing due diligence and of considering common law principles prior to foreclosure was highlighted in *Hawkeye Land Co. v. Laurens State Bank*[17]. In that case, 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 of the site. When Koenig defaulted on his lease, 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 this time, Koenig had also defaulted on his loan obligation with Laurens, 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 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 the USTs, it received an offer from a salvage company and requested that the bank 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, the bank insisted that $1500 of the $3500 sale price be paid to the bank in exchange for release of its interest in the improvements. When the sale fell through, the plaintiff then filed suit against the bank seeking injunctive relief ordering the bank to remove the storage tanks.

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 tanks to be deemed the owner of the improvements, and that their continued unwanted presence amounted to a trespass. Therefore, the court ordered the bank to remove the storage tanks.

The case demonstrates another limitation in the EPA lender liability rule. The rule was issued two weeks after the decision, but even if the EPA had acted earlier, the bank could not have raised the rule as a defense because the tank closure requirements imposed on the bank stem from the federal Resource Conservation and Recovery Act (RCRA), and the lender liability rule only addresses liability under CERCLA. The number of properties potentially subject to cleanups 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 storage tanks to store hazardous chemicals, fuel, solvents, degreasers, thinners, dyes, or paints.

The timing of the environmental due diligence was a critical factor in Chase *Lincoln Bank v. Kesserlring-Dixon*,[18] 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, the bank 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 15 months after it was granted, and sought 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 of this case is that a lender should perform

17. 480 N.W.2d 854 (Iowa 1992).

18. 554 N.Y.S.2d 379 (Sup. Ct. 1990).

environmental due diligence prior to exercising any of its rights.

Gaining access to a site to perform an environmental audit can be a problem, especially when a borrower has defaulted and relations between the bank and its borrower have deteriorated. In *Resolution Trust Corp. v. Polmar Realty, Inc.*,[19] a federal district court 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. While a 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 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 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 and that a Phase II audit fell within that authority. However, the court imposed conditions on the lender to make sure that the audit disrupted the borrower's business as little as possible, that the test would be performed carefully and in accordance with law, and that the lender provided 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 ensure that they contain provisions providing a right of entry. It may also be advisable to allow specifically for the performance of environmental audits. ■

19. 700 F.Supp. 177 (SDNY 1991).

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