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Progressing toward Clarification of Lender Liability under CERCLA

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PROGRESSING TOWARD CLARIFICATION OF LENDER LIABILITY UNDER CERCLA

JOHN C. PENBERTHY III†

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I. INTRODUCTION

A considerable regulatory, legislative and judicial battle has coursed through the United States legal system since Congress enacted the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA")¹. While liability issues amongst generators and operators of contaminated sites were clarified fairly

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1. Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA") §§ 101-308, Pub. L. No. 96-510, 94 Stat. 2767 (1980) (codified as amended at 42 U.S.C. §§ 9601-75 (1988 & Supp. IV 1992)).

quickly,² lenders have had great difficulty assessing their risk under CERCLA. Recently, courts and the United States Environmental Protection Agency ("EPA") have carved out rational interpretations of the lender liability "safe harbor" contained in CERCLA.³ While Congress has chosen not to clarify the exception, the author believes that recent federal court decisions and EPA action suggest a trend toward broadening the scope of the exemption.

This Article first provides an overview of the purpose behind CERCLA. It explores how conflicting policies have caught lenders in a maze of legislative, regulatory and judicial ambiguity which after fifteen years is finally approaching a consensus. This Article then discusses related state law claims as well as a state lender exemption which closely mirrors the EPA Lender Rule. Finally, the Article focuses on basic steps which a lender can take to reduce risk at the beginning of a lending relationship to ameliorate concerns about environmental contamination discovered after monies have been exchanged and collateral pledged.

II. OVERVIEW OF CERCLA LEGISLATION

In 1980, Congress enacted CERCLA which created a \$1.6 billion superfund that enabled EPA to clean up various sites contaminated by hazardous waste.⁴ Congress later increased the fund to \$8.5 billion pursuant to the Superfund Amendments and Reauthorization Act of 1986 ("SARA"),⁵ which was integrated with CERCLA.

CERCLA seeks to hold all past and present owners or operators⁶ of a contaminated facility liable for clean-up costs.⁷ CERCLA

2. See, 42 U.S.C.A. § 9601-75, as amended Pub.L. 99-499, Title I, §§ 101, 114(b), 127(a), Title V, § 517(c)(2), 100 Stat. 1615, 1652, 1774; Pub.L. 100-707, Title I, § 109(v), 102 Stat. 4710; Pub.L. 102-426, § 1, 106 Stat. 2174 (West 1994).

3. See CERCLA § 101(20)(A), 42 U.S.C. § 9601(20)(A). For a further discussion of the lender liability exemption contained within CERCLA's definition of "owner or operator," see *infra* note 14 and accompanying text.

4. CERCLA § 131, 42 U.S.C. § 9631, *repealed by* Superfund Amendments and Reauthorization Act ("SARA"), Pub. L. No. 99-499, 100 Stat. 1774 (1986).

5. Superfund Amendments and Reauthorization Act ("SARA"), Pub. L. No. 99-499, 100 Stat. 1774 (1986).

6. See CERCLA § 101(20)(A), 42 U.S.C. § 9601(20)(A). For a further discussion of CERCLA's definition of the term "owner or operator," see *infra* note 7, and accompanying text.

7. *Id.* § 107(a), 42 U.S.C. § 9607(a). The relevant language of this section provides:

[T]he owner and operator of a vessel or a facility . . . shall be liable for —
(A) all costs of removal or remedial action incurred by the United States Government or a State or an Indian tribe not inconsistent with the national contingency plan;

section 107(a) provides that an owner or operator of a vessel or facility where hazardous substances were disposed of shall be liable for the costs of cleanup, damages and interest where remedial action is required if a release⁸ or threatened release of a hazardous substance occurs.⁹ Courts have interpreted this liability provision as calling for strict liability. Furthermore, courts interpreting the liability sections of CERCLA have sought to promulgate uniform rules to ensure consistent enforcement of environmental legislation enacted by Congress.¹⁰ As a result, a federal common law has emerged as a supplement to CERCLA.¹¹

(B) any other necessary costs of response incurred by any other person consistent with the national contingency plan;

(C) damages for injury to, destruction of, or loss of natural resources, including the reasonable costs of assessing such injury, destruction, or loss resulting from such a release; and

(D) the costs of any health assessment or health effects study carried out under section 9604(i) of this title.

Id.

A lender may be deemed an owner through foreclosure, or an operator through participation in management, and thereby be subject to CERCLA liability. Michael A. Kahn & Mary C. Castle, *Recent Developments in Lender Liability Litigation: RICO, CERCLA and Aiding and Abetting*, (PLI Comm. Law and Practice Course Handbook Series, 1990). Courts may determine on a case-by-case basis the degree of management required to classify a lender as an operator. *Id.*

Until recently, courts have shown great reluctance to allow a defendant with potential CERCLA liability to escape litigating such matters regardless of whether the suit has been brought by a governmental entity or for contribution by private parties. See *United States v. Fleet Factors Corp.*, 901 F.2d 1550 (11th Cir. 1990), *cert. denied*, 498 U.S. 1046 (1991); *Tanglewood East Homeowners v. Charles-Thomas, Inc.*, 849 F.2d 1568 (5th Cir. 1988). This interpretation is consistent with congressional intent to allocate the financial burden for cleanup of toxic wastes between those parties responsible for causing the contamination. See *Southland Corp. v. Ashland Oil, Inc.*, 696 F. Supp. 994, 998 (D.N.J. 1988). Unfortunately, most lenders never foresaw exposure to borrower's environmental problems prior to 1980.

8. A release includes any "spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping or disposing into the environment (including the abandonment or discarding of barrels, containers and other closed receptacles containing any hazardous substance or pollutant or contaminant). . . ." CERCLA § 101(22), 42 U.S.C. § 9601(22).

9. CERCLA § 107(a), 42 U.S.C. § 9607(a). For a further discussion of the text of this provision, see *supra* note 7.

10. *Smith Land & Improvement Corp. v. Celotex Corp.*, 851 F.2d 86, 92 (3d Cir. 1988), *cert. denied*, 488 U.S. 1029 (1989). As the court noted, "[i]n resolving the successor liability issues . . . the . . . court must consider national uniformity; otherwise, CERCLA aims may be evaded easily by a responsible party's choice to arrange a merger or consolidation under the laws of the particular states which unduly restrict successor liability." *Id.*

11. *Id.* at 91 (stating that sparseness of the legislative history "indicates that Congress expected the courts to develop a federal common law to supplement the statute."). See also *United States v. Nicolet, Inc.*, 712 F. Supp. 1193, 1201-02 (E.D. Pa. 1989) (discussing the need for uniform federal rules when "the application of state law would frustrate specific objectives of the federal program."); In re

CERCLA section 107(b) carves out three exceptions to the liability provisions: a defendant shall not be held liable if the release or threat of release of a hazardous substance and the damages resulting therefrom are caused by: (1) an act of God; (2) an act of war; or (3) an act of a third party not an employee or agent of the defendant when the defendant exercises due care and takes precautions against foreseeable acts.¹² Each defense is based on the fact that the defendant lacks the requisite element of causation under the strict liability doctrine.¹³

III. LENDER LIABILITY UNDER CERCLA

A. Lender Liability Exemption

In addition to the three liability defenses provided in CERCLA section 107(a), is another of utmost importance to lenders. In section 101(20), CERCLA provides that the term "owner or operator," does not include "a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility."¹⁴ This defense is actually created, therefore, through Congress' explicit exception of such parties from CERCLA's definition of "owner or operator." However, Congress left the meaning of both "indicia of

Acushnet River & New Bedford Harbor Proceedings, 675 F. Supp. 22, 31 (D. Mass. 1987) (noting that nature of CERCLA demands national uniformity).

12. CERCLA § 107(b), 42 U.S.C. § 9607(b). This section also allows as a defense any combination of these stated defenses. *Id.* § 107(b)(4), 42 U.S.C. § 9607(b)(4).

13. *United States v. Monsanto Co.*, 858 F.2d 160, 170 (4th Cir. 1988) (citing *New York v. Shore Realty Corp.*, 759 F.2d 1032, 1044 (2d Cir. 1985)).

Strict liability is defined as follows:

(1) One who carries on an abnormally dangerous activity is subject to liability for harm to the person, land or chattels of another resulting from the activity, although he has exercised the utmost care to prevent the harm.

(2) This strict liability is limited to the kind of harm, the possibility of which makes the activity abnormally dangerous.

RESTATEMENT (SECOND) OF TORTS § 519 (1977).

14. CERCLA § 101(20)(A)(iii), 42 U.S.C. § 9601(20)(A)(iii). The definition of "owner or operator," under CERCLA does specifically include:

[I]n the case of any facility, title or control of which was conveyed due to bankruptcy, foreclosure, tax delinquency, abandonment, or similar means to a unit of State or local government, any person who owned, operated, or otherwise controlled activities at such facility immediately beforehand.

Id. Thus, such parties are explicitly not permitted to use the lender liability exemption.

ownership," and "participation in management," for purposes of being considered an owner or operator under CERCLA unclear.¹⁵

B. Court Interpretations of the Lender Liability Exemption

CERCLA liability is remedial in that it spreads the costs of responding to improper waste disposal among all parties that played a role in creating the hazardous conditions.¹⁶ Courts generally apply the CERCLA liability provisions accordingly, and reject attacks based upon due process concerns.¹⁷ Such a broad and liberal construction of CERCLA is consistent with Congress' goal of enacting remedial legislation.¹⁸

In *United States v. Monsanto Co.*,¹⁹ the United States Court of Appeals for the Fourth Circuit carved out uniform federal rules concerning apportionment of liability under CERCLA.²⁰ The principle espoused by the court provides that damages for harm must be apportioned among two or more causes where there are distinct harms or a reasonable basis for determining the contribution of each cause to a single harm; damages for any other harm cannot be apportioned among two or more causes.²¹ The burden of establishing a reasonable basis for apportionment lies with the party responsible for generating the waste.²²

Allegations containing lender liability issues are premised on the contention that the lender is or was an owner or operator of a

15. Roslyn Tom, Note, *Interpreting the Meaning of Lender Management Participation Under Section 101(20)(A) of CERCLA*, 98 YALE L.J. 925, 926 (1989).

16. *Monsanto*, 858 F.2d at 174.

17. See, e.g., *id.* (stating "retroactive application of CERCLA does not violate due process"); *United States v. Northeastern Pharmaceutical & Chem. Co, Inc.*, 810 F.2d 726, 734 (8th Cir. 1986), *cert. denied*, 484 U.S. 848 (1987) (stating that "[c]leaning up inactive and abandoned hazardous waste disposal sites is a legitimate legislative purpose, and Congress acted in a rational manner in imposing liability for the cost of cleaning up such sites upon those parties who created and profited from the sites and upon the chemical industry as a whole").

18. See generally *Tanglewood East Homeowners*, 849 F.2d at 1572-74 (construing CERCLA terms "present owners," "facility," "disposal," and "treatment" broadly).

19. 858 F.2d 160 (4th Cir. 1988).

20. *Monsanto*, 858 F.2d at 172.

21. *Monsanto*, 858 F.2d at 172 (citing RESTATEMENT (SECOND) OF TORTS § 433A (1965)).

22. *Id.* (citing *United States v. ChemDyne*, 572 F. Supp. 802, 810 (S.D. Ohio 1983)). Where the combination of tortious conduct of two or more actors causes a single harm to a plaintiff, and one or more of those actors wants to limit his liability on the ground that the harm is divisible, that actor has the burden of proof as to apportionment. RESTATEMENT (SECOND) OF TORTS § 433B (1965).

hazardous waste facility.²³ The typical situation in which a lender is named as a defendant occurs during a workout or after a lender forecloses on contaminated real estate.²⁴ The most difficult issue arises within this context when a secured creditor must determine what measures to take to protect its financial interests without being found to have acted as an owner or operator within the meaning of the statute. Courts have diverged over the proper standard to apply when making this determination. A review of case law aids in understanding the implications of "management participation" and "indicia of ownership" standards.

1. *Exercise of Security Interest*

The first reported case to deal with the lender exemption²⁵ to CERCLA liability was *In re T.P. Long Chemical, Inc.*²⁶ The bankruptcy court in *T. P. Long* stated in dicta that a secured lender, ("Bank"), would not incur owner or operator liability for toxic waste if it had repossessed its collateral pursuant to a security agreement because the Bank had not participated in "management."²⁷ The issue was raised only marginally by EPA and no further explanation of this analysis was given in the opinion.²⁸

Judge Newcomer of the United States District Court for the Eastern District of Pennsylvania developed the "management participation" test in *United States v. Mirabile*,²⁹ when he stated that participation which is critical to finding a secured lender liable occurs in *operational, production, or waste disposal activities*.³⁰ Mere financial

23. James E. Spiotto, *The Problem of Indentured Trustees and Bond Holders 1990: Defaulted Bonds and Bankruptcy*, (PLI Real Estate Law and Practice Course Handbook Series, 1990).

24. See, e.g. *United States v. McLamb*, 5 F.3d 69 (4th Cir. 1993) (discussing defense of secured creditor who took legal title through foreclosure); *In re Bergsoe Metal Corp.*, 910 F.2d 668 (9th Cir. 1990) (discussing liability of local port authority during "workout" situation); *Fleet Factors Corp.*, 901 F.2d at 1553; *Kemp Industries, Inc. v. Safety Light Corp.*, 857 F. Supp. 373 (D.N.J. 1994) (holding defendant who financed construction project through sale and leaseback was not responsible party under CERCLA); *Guidice v. BFG Electroplating and MFG. Co., Inc.*, 732 F. Supp. 556 (W.D. Pa. 1989) (determining liability of bank prior to foreclosure and purchase of site and period during bank's ownership).

25. See *supra* notes 14-15, and accompanying text.

26. 45 B.R. 278, 288 (Bankr. N.D. Ohio 1985).

27. *Id.* at 288-89. The court noted that the only indicia of ownership that could possibly be attributed to the Bank is "that which is primarily to protect its security interest." *Id.* at 289.

28. *Id.* at 288. EPA asserted that the Bank was liable for EPA's costs, yet EPA never expressly alleged that the Bank was an owner or operator under CERCLA. *Id.*

29. 15 Env'tl. L. Rep. (Env'tl. L. Inst.) 20,992 (E.D. Pa. 1985).

30. *Id.* at 20,995 (emphasis added).

ability to control waste disposal practices possessed by a secured creditor was not deemed sufficient for the imposition of liability.³¹ The court did not discuss whether the creditor met the test for liability as an owner, and the case cannot be viewed as a complete "safe harbor" for lenders who purchase property at a foreclosure sale.³²

In *United States v. Maryland Bank & Trust Co.*,³³ the District Court of Maryland dealt squarely with the definition of "owner or operator" under CERCLA section 101(20)(A).³⁴ In *Maryland Bank & Trust*, a secured lender foreclosed on contaminated property and continued to hold the waste site at the time EPA initiated suit.³⁵ In finding the creditor liable for the costs of cleanup, the court construed the CERCLA section 101(20)(A) exemption narrowly.³⁶ The court decided that "[t]he exemption of subsection (20)(A) covers only those persons who, at the time of the cleanup, hold indicia of ownership to protect a then-held security interest in the land."³⁷ The court stressed the importance of the verb tense

31. *Id.* The level of participation in management by the secured creditor in *Mirabile* was too attenuated to permit the imposition of liability. *Id.* In this situation, the participation was limited to financial decisions. *Id.*

In *Mirabile*, one of the creditors purchased contaminated property at a foreclosure sale and four months later assigned the property to a buyer. *Id.* at 20,996. The court held that securing the property against vandalism, showing it to prospective purchasers, and inquiring about the cost of waste disposal were done to protect ABT's financial position in the property and did not bring it under the owner/operator liability provision. *Id.* at 20,996.

32. Kahn & Castle, *supra* note 7, at 460. In its analysis, the court focused solely on operator status as a trigger for CERCLA liability and disregarded liability as an owner. *Id.*

33. 632 F. Supp. 573 (D. Md. 1986).

34. *Id.* at 575. The court noted that because CERCLA was to be interpreted broadly to effect Congress' remedial goals, the burden of proof was on the lender to establish entitlement to the security interest exemption. *Id.* at 578. For a further discussion of CERCLA's definition of "owner or operator," see *supra* note 14 and accompanying text.

35. *Id.* at 575.

36. *Id.* at 579. The court also noted that the defendant had the burden of proving that it was entitled to a statutory exemption to a congressionally imposed rule of general liability. *Id.* at 578.

37. *Maryland Bank & Trust*, 632 F. Supp. at 579. The defendant, Maryland Bank & Trust Company, argued that it was entitled to the benefit of the statutory exemption for lenders because it acquired ownership of the contaminated site through foreclosure on its security interest in the property and purchase of the land at the foreclosure sale. *Id.* The court found the government's assertion, that the defendant bank was not entitled to the exemption as a matter of law, more persuasive, and held that the defendant was not relieved from liability by the exemption found in CERCLA § 101(20)(A). *Id.* The court concluded that the creditor did not purchase the property at the foreclosure sale to protect its security interest, but rather to protect its investment. *Id.*

used in the exclusionary language, emphasizing that the security interest must exist at the time of the cleanup.³⁸

The *Maryland Bank & Trust* court distinguished *Mirabile* based on the time difference in the lender's ownership.³⁹ The court noted that in *Mirabile*, the lender assigned its mortgage almost immediately and closed the transaction within four months of foreclosure.⁴⁰ Conversely, in *Maryland Bank & Trust*, the Bank purchased the property at a foreclosure sale and still held title four years later.⁴¹ The *Maryland Bank & Trust* court rejected *Mirabile's* broad construction of CERCLA section 101(20)(A), stating that a broad construction would be contrary to the legislative history and policies of CERCLA.⁴²

Courts have also faced the issue of whether a mortgagee bank can use the security interest exemption to avoid CERCLA liability. The case of *Guidice v. BFG Electroplating and Manufacturing Co., Inc.*,⁴³ involved a suit brought by residents of the Borough of Punxsutawney, Pennsylvania ("Borough") against BFG Electroplating Company ("BFG").⁴⁴ BFG subsequently filed a third-party complaint against the past and present facility owners, including the National Bank of the Commonwealth ("Bank") seeking indemnification, contribution and response costs based upon toxic discharges from BFG's plant.⁴⁵ The District Court for the Western District of Pennsylvania held that actions taken by the Bank prior to foreclosure fell within CERCLA's secured lender exemption because the Bank did not participate in managerial aspects of the fa-

38. *Id.* The exclusion does not apply to former mortgagees currently holding title after purchasing the property at a foreclosure sale, at least when the former mortgagee has held title for nearly four years and a full year before EPA begins cleanup, as was the case in *Maryland Bank & Trust. Id.*

39. *Id.* at 580.

40. *Id.*

41. *Maryland Bank & Trust*, 632 F. Supp. at 575.

42. *Id.* at 580 (stating legislative history counsels against generously reading CERCLA § 101(20)(A) exclusion). The court, however, provided the creditor with a potential safe harbor. The government brought a motion for summary judgment seeking to preclude the creditor from avoiding liability by using the "innocent land owner" defense found in CERCLA § 107(b)(3). *Id.* at 581. The court denied the motion, holding that a lender is an "innocent land owner" if it can show by a preponderance of the evidence that the damage caused by the release or threat of release of hazardous substances was caused solely by an act or omission of a third party, and that the [lender] exercised "due care" in light of all relevant circumstances and took precautions against foreseeable acts or omissions by third parties. *Id.*

43. 732 F. Supp. 556 (W.D. Pa. 1989).

44. *Id.* at 557. BFG was alleged to have unlawfully contaminated the environment, thereby causing personal injuries. *Id.*

45. *Id.*

cility, but merely acted to protect its security interest in the property.⁴⁶ The court then determined that the security interest exemption did not apply to a secured creditor who purchased its security interest at a foreclosure sale.⁴⁷

The *Guidice* court concurred with the decision in *Maryland Bank & Trust*, noting that once the lender foreclosed and purchased the property, the lender held it as an investment rather than as a security interest and thus forfeited the benefit of the security interest exemption.⁴⁸ The court reasoned that extending the secured lender exemption to lenders holding full title would frustrate the distribution of clean-up costs as allocated under CERCLA, and shift the risks assumed in owning real property.⁴⁹ Furthermore, the court stated that exempting "landowning lenders would create a special class of otherwise liable land owners."⁵⁰ Consequently, lenders should be circumspect when contemplating foreclosure and subsequent leasing of contaminated property.

2. United States v. Fleet Factors Corp., and Its Fallout

Two subsequent Courts of Appeal decisions muddled the parameters of the lender liability exception under CERCLA. In *United*

46. *Id.* at 561-62. Interpretations of "participating in the management," and "primarily to protect its security interest," permit secured creditors to provide financial assistance and general, or even isolated specific management advice to their debtors without risking liability under CERCLA, as long as the lender does not actually participate in daily management. *Id.* at 561.

The court noted that prior to foreclosure, a mortgagee may benefit from the secured lender exemption as long as the mortgagee did not participate in the managerial and operational aspects of the facility. *Id.* These actions included touring the plant with plant officials to discuss management, company accounts, work shifts, the presence of raw materials and advocating that the company take out a Small Business Administration loan to pay off debt and raise working capital. *Id.* at 562. The court regarded these preforeclosure activities as inadequate to forfeit the CERCLA security interest exemption, and noted that there was no evidence to indicate that the Bank controlled operations, production, or waste disposal activity. *Id.* Rather, the measures taken by the Bank were consistent with a desire to protect its security interest in its property. *Id.*

47. *Guidice*, 732 F. Supp. at 562-63. The Bank foreclosed on the property and purchased it at sheriff's sale, leased the property to a new manufacturer and began receiving rental payments. *Id.* at 559. Approximately eight months later the Bank deeded the property to a trust which had been formed to manage the rental income and continued to receive payments through the trust, which reduced the original loss from the default on the loan. *Id.*

48. *Id.* at 563.

49. *Id.*

50. *Id.* The fact that Congress did not specifically provide for a mortgagees-turned-landowners exemption in the 1986 SARA Amendments strongly indicated to the court that such an exemption would contradict Congressional intent. *Id.*

States v. Fleet Factors Corp.,⁵¹ EPA sued Swainsboro Print Works ("SPW"), SPW's two principal officers, and SPW's secured lender ("Fleet Factors") for the costs of cleaning up SPW's toxic waste site.⁵² Fleet Factors foreclosed on its security interest and subsequently auctioned off SPW's machinery and equipment.⁵³ Thereafter, EPA inspected and began to clean up the SPW site.⁵⁴ EPA then sued all parties for recovery of the clean-up costs.⁵⁵

Reiterating the Congressional policy behind CERCLA to place the ultimate responsibility for cleaning up hazardous wastes on those parties responsible for problems caused by improper disposal, the court denied Fleet Factors' motion for summary judgment which sought to dismiss EPA's claim, despite the fact that Fleet did not own or control the facility between December 1983 and July 1987 when the property was sold.⁵⁶ The court noted that it was Fleet Factors' burden to prove its entitlement to the security interest exemption from CERCLA liability and that Fleet Factors had not presented any evidence concerning the nature and extent of its involvement.⁵⁷ The court proceeded to adopt a standard whereby the trier of fact focuses on whether a lender's participation in financial management of a facility indicates "a capacity to influence" the corporation's practices concerning treatment and disposal of hazard-

51. 901 F.2d 1550 (11th Cir. 1990), *cert. denied*, 498 U.S. 1046 (1991).

52. *Id.* at 1552-53. SPW ran a cloth printing business until 1979 when it filed for Chapter 11 reorganization. *Id.* at 1552. Fleet Factors continued to finance the debtor until early 1981. *Id.* Subsequently, the case was converted to a Chapter 7 proceeding and the Bankruptcy Court appointed a trustee. *Id.*

53. *Id.* at 1552-53.

54. *Id.* at 1553. EPA found 700 fifty-five gallon drums containing toxic chemicals and 44 truckloads of material containing asbestos. *Id.* EPA incurred nearly \$400,000.00 in clean-up costs. *Id.*

55. *Fleet Factors*, 901 F.2d at 1553.

56. *Id.* at 1555. EPA urged the court to adopt a literal interpretation of the lender liability exemption that would exclude any secured lender that participates in any form of facility management. *Id.* at 1556. Fleet Factors, on the other hand, asserted that the court should distinguish between permissible participation in financial management and impermissible participation in the daily or operational management of a facility. *Id.* The court rejected the government's narrow interpretation finding that, "it would largely eviscerate the exemption Congress intended to afford to secured creditors To adopt the government's interpretation of the secured creditor exemption could expose all such lenders to CERCLA liability for engaging in their normal course of business." *Id.*

57. *Id.* at 1555-56 (citing *Maryland Bank & Trust*, 632 F. Supp. at 578). There was no dispute that Fleet Factors held indicia of ownership in the facility through its deed of trust to SPW and that this interest was held essentially to protect its security interest in the facility. *Id.* at 1556. Thus, the critical issue was whether Fleet Factors participated in management sufficiently to incur liability under CERCLA. *Id.*

ous waste.⁵⁸ Accordingly, the *Fleet Factors* court held that a secured creditor will be held liable if its management activities are sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it chose to do so.⁵⁹ The court indicated that this construction of the secured lender exemption gives lenders some latitude in their dealings with debtors without exposing them to CERCLA liability.⁶⁰

The Ninth Circuit subsequently addressed the CERCLA section 101(20)(A) secured lender exemption in *In re Bergsoe Metal Corp.*⁶¹ In *Bergsoe*, a municipal corporation, the Port of Saint Helens ("Port"), foreclosed on municipal bonds which it had raised to support a lead recycling plant built to promote industrial development in the Saint Helens, Oregon area.⁶² The lead recycling plant failed financially, and a creditor of the plant's builder put the builder into involuntary bankruptcy under Chapter 11 after workout attempts failed.⁶³ The Port subsequently filed a summary judgment motion to determine that it was not an owner or operator of the lead recycling plant under CERCLA.⁶⁴

The court held that the Port was not an owner or operator for purposes of CERCLA.⁶⁵ Although the Port had legal title to the

58. *Id.* at 1557. The court explained that "[i]t is not necessary for the secured creditor actually to involve itself in the day-to-day operations of the facility in order to be liable — although such conduct will certainly lead to the loss of the protection of the statutory exemption." *Id.* at 1557-58.

59. *Fleet Factors*, 901 F.2d at 1558. Thus, the *Fleet Factors* court expressly rejected the interpretation of the secured lender exemption espoused by the District Court for the Eastern District of Pennsylvania in *Mirabile*. *Id.* The court stated that its narrow construction of the exemption is supported by the limited legislative history available on the subject. *Id.* (citing S. 1489, 97th Cong., 2d Sess., reprinted in 2 Senate Comm. On Environmental and Public Works, 97th Cong., 2 Sess., 1 A LEGISLATIVE HISTORY OF CERCLA 470 (Comm. Print 1983)).

60. *Id.* Nothing precludes a secured lender from monitoring any aspect of a debtor's business. *Id.* Also, a secured lender may occasionally make decisions relating to protecting its security interest without incurring liability. *Id.*

61. 910 F.2d 668 (9th Cir. 1990).

62. *Bergsoe*, 910 F.2d at 669-70.

63. *Id.* at 670.

64. *Id.* The Port argued that it did not own the plant for CERCLA purposes and, therefore, it had no CERCLA liability. *Id.* The court noted that, in one sense the Port owned the plant because the deed to the property was in its name. *Id.* Yet, the Port asserted that it was not a CERCLA owner because it fell within the security interest exemption. *Id.* The court stated that the Port could only prevail on summary judgment if the undisputed facts demonstrated that the Port held indicia of ownership primarily to protect its security interest in the plant and that the Port did not participate in plant management. *Id.*

65. *Id.* at 673. The court found no material issue of fact, and concluded that the Port held indicia of ownership primarily to protect its security interest and did not participate in plant management. *Id.*

property, it never participated in any management decisions concerning the facility.⁶⁶ Therefore, the *Bergsoe* court explicitly withheld ruling on the viability of the *Fleet Factors* "capacity to influence" test because "there must be *some* actual management of the facility before a secured creditor will fall outside" the security interest exemption, and here there was none.⁶⁷ Ultimately, the Ninth Circuit held that the critical inquiry is not what rights the secured lender holds, but what the secured lender does.⁶⁸

This decision gives secured lenders hope that a more rational test than the "capacity to influence" decisions enunciated in *Fleet Factors* will prevail. *Bergsoe* implicitly held that even if a lender owns the property, regardless of what its capacity to influence may be, the determination of liability rests on what it has actually done. The problem for lenders after the *Bergsoe* holding is that *Fleet Factors* is the only Court of Appeals case to deal directly with the security interest exemption. In the absence of direction from either Congress or the Supreme Court regarding the proper construction of the CERCLA security interest exemption, courts have been forced to fashion their own concepts of this exception. As a result, there is a lack of judicial consistency on the issue.

In the wake of *Fleet Factors*, some courts have chosen to limit the harshness of, or to ignore the Eleventh Circuit's "capacity to influence" test. In *Northeast Doran, Inc. v. Key Bank of Maine*,⁶⁹ the First Circuit Court of Appeals held that a lender ("Key Bank") was protected under CERCLA section 101(20)(A), without examining the creditor's capacity to control.⁷⁰ In *Doran*, Key Bank sold contaminated property at a foreclosure sale without informing the purchaser about the environmental problem.⁷¹ The plaintiff alleged that Key Bank was not entitled to CERCLA's security interest holder exemption because of its knowledge of potential contamination prior to and at the time of sale.⁷² The court stated that, "[w]hile Key [Bank], having obtained a judgment of foreclosure on the property, might appear at first glance to be an 'owner' or 'operator'

66. *Bergsoe*, 901 F.2d at 672.

67. *Id.* (emphasis in original). Accordingly, the court refused to consider the argument that the Port had the capacity to exercise rights under the lease such as inspection, re-entry and taking possession of the property upon foreclosure because nearly all secured creditors reserve these rights. *Id.*

68. *Id.*

69. 15 F.3d 1 (1st Cir. 1994).

70. *Id.* at 2-3.

71. *Id.* at 2.

72. *Id.* The lower court dismissed the plaintiff's complaint for failure to state a claim upon which relief could be granted. *Id.*

of the property for purposes of section 9607(a), CERCLA's definition provisions clearly dictate otherwise."⁷³ The court explained that the exemption is designed to shield from liability those "owners" who are in essence lenders holding title only as a security interest for the debt.⁷⁴ Accordingly, the court held that mere possession of an environmental audit showing contamination and transfer of title at a foreclosure sale did not remove Key Bank from the reach of CERCLA's secured lender exemption.⁷⁵ Although practitioners should not advise their lending clients to withhold disclosure in jurisdictions that require sellers to come forward with relevant problems related to real estate sales, they should warn buyers to carefully evaluate due diligence practices prior to making any purchase.⁷⁶

In *United States v. McLamb*,⁷⁷ EPA brought suit against landowners for response costs incurred in the cleanup of a contaminated site.⁷⁸ The landowner defendants subsequently filed a third-party complaint against Wachovia Bank and Trust Co., N.A. ("Wachovia") for fraud, negligent misrepresentation, breach of implied warranty and contribution under CERCLA and North Carolina law.⁷⁹ The district court granted summary judgment in favor of Wachovia on

73. *Dornan*, 15 F.3d at 2 (citing CERCLA § 101(20)(A), 42 U.S.C. § 9601(20)(A)).

74. *Id.* at 2 (citing *Waterville Indus., Inc. v. Finance Auth. of Maine*, 984 F.2d 549, 552 (1st Cir. 1993)). Furthermore, the court stated:

[S]o long as the [security interest holder] makes a reasonably prompt effort to divest itself of its unwelcome ownership, we think continued coverage under the exception serves its basic policy: to protect bona fide lenders and to avoid imposing liability on owners who are not in fact seeking to profit from the investment opportunity normally presented by prolonged ownership.

Id. at 2-3 (quoting *Waterville*, 984 F.2d at 553).

75. *Id.* at 3.

76. See Jeffrey M. Sharp, *Environmental Lender Liability: Evaluating Risks Facing Residential Lenders Under Common Law Theories*, 23 Real Est. L. J. 236, 240 (W.G.L. 1994) ("Failure to disclose latent defects can support two primary theories of negligence and misrepresentation.").

77. 5 F.3d 69 (4th Cir. 1993).

78. *Id.* at 71.

79. *Id.* at 70. After Wachovia exercised its rights as beneficiary under a deed of trust and foreclosed on a property whose owner was in default, sale of the property was conducted according to state law. *Id.* However, there was no bidder at the sale other than Wachovia. *Id.* As a result, Wachovia purchased the land solely to protect its security interest and soon thereafter contracted with realtors to sell the property. *Id.* Wachovia did not attempt to develop or manage the property following foreclosure. *Id.* The district court concluded that Wachovia had no knowledge of the contamination on the property prior to taking a security interest. *Id.*

the ground that Wachovia was exempt from liability under the security interest exemption.⁸⁰

In affirming the district court, the Fourth Circuit refused to interpret the exemption narrowly.⁸¹ The *McLamb* Court drew an analogy to *Bergsoe*, and reasoned that Wachovia, like the lender in *Bergsoe*, took title to contaminated property for financial security reasons and not to profit from the underlying business.⁸² The *McLamb* decision clarified efforts to foreclose on contaminated property and carved a broad exemption for lenders who take title to market and sell the property.

The district court in *Kelley Ex. Rel. Michigan Natural Resources Commission v. Tiscornia*,⁸³ upheld the application of CERCLA's lender exemption where the lender, in exchange for continued financing, required the debtor to make daily reports, prohibited outside financing, banned dividends, and was granted a blanket lien on all machinery and equipment.⁸⁴ The court granted summary judgment for the bank pursuant to the security interest exception of CERCLA and the EPA lender liability rule.⁸⁵ The *Kelley* court rejected a narrow reading of the exclusion from liability for persons who "without participating in the management of a vessel or facility, hold indicia of ownership primarily to protect securing interests in the vessel or facility."⁸⁶ Daily monitoring and suggestions concerning the debtor's financial condition were insufficient

80. *Id.* The appellant landowners maintained that Wachovia was liable for clean-up costs as an "owner" of the contaminated site and should not benefit from the security interest exemption. *Id.* They further argued that Wachovia should not benefit because it did not act in a commercially reasonable manner after it took title to the property. *Id.*

81. *McLamb*, 5 F.3d at 72 (citing *Waterville*, 984 F.2d at 552). The appellants argued that Wachovia should not be able to rely on the secured lender exemption because as a result of the foreclosure sale, the bank owned the property for at least several months. *Id.* Once the bank exercised its rights under the deed of trust, the appellants argued, the bank lost its status as one who holds indicia of ownership primarily to protect its security interest. *Id.* The court rejected this narrow interpretation, explaining that there is nothing in CERCLA itself that mandates a reading of the security interest exemption to "apply solely to the classic mortgage/mortgagee arrangement." *Id.*

82. *Id.* The *McLamb* court noted that the *Bergsoe* court stated that "under the security interest exception the court must determine why the creditor" holds such indicia of ownership. *Id.* (quoting *Bergsoe*, 910 F.2d at 671).

83. 810 F. Supp. 901 (W.D. Mich. 1993).

84. *Id.* at 903. The bank even recommended a turnaround specialist who was hired and ran the company as President and CEO for nearly two years. *Id.*

85. *Id.* at 909. For a discussion of the EPA lender liability rule, see *infra* notes 133-54, and accompanying text.

86. *Id.* at 905 (citing CERCLA § 107(a)(2), 42 U.S.C. § 9607(a)(2)). The court stated that in deciding this case, it was necessary to analyze the actual role played by the lender in the management of the company at the time. *Id.*

to impose CERCLA liability, and the lender could be shielded by the security interest exception.⁸⁷

IV. CERCLA EXEMPTION READ IN CONJUNCTION WITH STATE LAW UNDER LEASEBACK ARRANGEMENTS

A. Application of Leaseback Arrangements to CERCLA

A recent district court opinion, *Kemp Industries, Inc. v. Safety Light Corp.*,⁸⁸ furthers the trend of broadening the lender exception under CERCLA, and applies a similarly broad standard allowing a lender to vigorously pursue its security interest under the recently enacted lender exception to the New Jersey Spill Compensation and Control Act ("Spill Act").⁸⁹ In *Kemp*, the plaintiff brought a recovery action under CERCLA and the Spill Act against several parties, including the Prudential Insurance Company of America ("Prudential").⁹⁰ Prudential had financed the debtor's property, formerly the site of a radium processing plant, through the use of a sale-leaseback arrangement, whereby Prudential took title to the property and leased it back to the debtor under a long term lease which vested control over the property with the debtor.⁹¹

The *Kemp* court described a leaseback arrangement as akin to a mortgage financing arrangement in that the leaseback benefits a debtor because the restrictions imposed under a traditional lending arrangement are not present.⁹² Because insurance companies and pension funds normally invest in such deals and are interested solely in a financial return, the debtor has the same broad control over the property as it would with formal ownership.⁹³ In holding the lender exemption applicable to Prudential, the court relied on the *Bergsoe* line of cases which broadly applied the exemption.⁹⁴

87. *Kelly*, 810 F. Supp. at 909. The court noted that "individually and collectively, the indicia relate to financial or administrative aspects of the business, as opposed to the operational aspects necessary for a finding of liability" *Id.*

88. 857 F. Supp. 373 (D.N.J. 1994).

89. N.J. STAT. ANN. § 58:10-23.11 (West 1994).

90. *Kemp*, 857 F. Supp. at 374.

91. *Id.* at 378-82. Industrial contaminants continued to be disposed of at the property during Prudential's ownership under the "leaseback." *Id.* at 376.

92. *Id.* at 376-77. Commercial mortgage financing generally requires 25% equity in the property after the loan is made.

93. *Id.* at 377. The plaintiffs contended that Prudential was an owner when hazardous substances were disposed of at the property. *Id.* at 384. Prudential countered that it was never a CERCLA owner or operator because it held indicia of ownership solely to protect its security interest in the lease. *Id.*

94. *Kemp*, 857 F. Supp. at 385. For a further discussion of the *Bergsoe* line of cases, see *supra* notes 61-87, and accompanying text.

Citing a congressional report concerning the exemption, the court stated:

The fact that a party garners secondary benefits from its ownership of the property, such as depreciation of the property for tax purposes, will not void its entitlement to the exemption. As one congressional report noted: “[A] financial institution which held title primarily to secure a loan but also received tax benefits as the result of holding title would not be an “owner” as long as it did not participate in the management or operation of the vessel or facility.”⁹⁵

Thus, the *Kemp* court approved alternative mortgage-type financing arrangements.⁹⁶ The court used a favorable test for determining whether Prudential had the “capacity to influence” environmental or operational aspects of the property through the leaseback arrangement.⁹⁷ The court framed the dispositive issue as: “In administering the [leaseback] Program, Prudential acted as a financier and was not interested in owning or operating an industrial facility. In fact, as a financier, and not a chemical manufacturer, Prudential did not have the capacity to operate an industrial facility of the type constructed on Lot 13.”⁹⁸ By approving a leaseback arrangement, *Kemp* ignored the holdings in *Guidice* and *Maryland Bank & Trust*, since the leaseback arrangement was held by the lender for investment purposes only. This holding closely reflects sound business practices in light of the fact that a lender always “invests” in a debtor’s business. Courts holding to the contrary ignore business reality and discourage real estate lending.

B. Leaseback Arrangement Under the Spill Act

The New Jersey Legislature passed the New Jersey Spill Compensation and Control Act (“Spill Act”)⁹⁹ to “control the transfer and storage of hazardous substances in New Jersey.”¹⁰⁰ The legislation is remedial and thus is applied retroactively.¹⁰¹ The Spill Act

95. *Id.* at 385 (citing H.R. Rep. No. 1016, 96th Cong., 2d Sess (1980), *reprinted in* 1980 U.S.C.A.N. 6119, 6181).

96. *Id.* (citing *Waterville*, 984 F.3d at 552).

97. *Id.* at 389-90.

98. *Kemp*, 857 F. Supp. at 390 (footnotes omitted).

99. Spill Compensation and Control Act (“Spill Act”), N.J. STAT. ANN. § 58:10-23.11-10-24 (West 1993 & Supp. 1994).

100. *Id.* § 58:10-23.11a.

101. *Kemp*, 857 F. Supp. at 396-97 (noting “curative” nature of Spill Act’s provisions).

provides a remedy for private litigants to the extent that it is not preempted by CERCLA.¹⁰² The Spill Act also allows the New Jersey Department of Environmental Protection and Energy to sue, for remedial costs, any person who discharged a hazardous substance or is in any way responsible for any hazardous substance.¹⁰³ Like CERCLA, the New Jersey Spill Act contains an exemption for secured creditors.¹⁰⁴ The Spill Act exemption provides:

A person who maintains indicia of ownership of a vessel or facility primarily to protect a security interest in a vessel or facility and who does not participate in the management of the vessel or facility is not deemed to be an owner or operator of the vessel or facility, shall not be deemed the discharger or responsible party for a discharge from the vessel or facility and shall not be liable for cleanup costs or damages resulting from discharges from the vessel or facility . . . except to the extent that liability may still apply to holders after foreclosure as set forth in section 3 of this act.¹⁰⁵

The terms of art in this exemption are defined and elaborated more fully in other sections of the Spill Act and provide a foreclosing mortgagee a minimum of five years to sell the property so long as “commercially reasonable” steps are taken to assess contamination problems and liquidate the lender’s debt through sale or lease of the property.¹⁰⁶

While the Spill Act’s exemption is more specifically defined than CERCLA section 101(20)(A), the *Kemp* court, citing the similarities with CERCLA, held that both exemptions should be applied consistently.¹⁰⁷ The *Kemp* court cited several salient sections of the Spill Act, specifically that lease financing transactions are protected, so long as title is held to protect a security interest and that participation in management means “[actual] participation in management . . . or operational affairs . . . and shall not include the mere capacity, or ability to influence, or the unexercised right to control

102. See *Exxon Corp. v. Hunt*, 534 A.2d 1, 2-3 (N.J. 1987).

103. N.J. STAT. ANN. § 58:10-23.11(f)(a)(2).

104. *Id.* § 58:10-23.11(g)(5).

105. *Id.*

106. *Id.* § 58:10-23.11(g)(6)(d).

107. *Kemp*, 857 F. Supp. at 396-97 (citing N.J. STAT. ANN. § 58:10-23.11(g)(4)).

vessel or facility operations.”¹⁰⁸ This language directly contradicts the *Fleet Factors* court’s analysis.¹⁰⁹

The *Kemp* case is a first-impression application of the lender exemption as contained in the New Jersey Spill Act. The court’s analysis is consistent with the recent broadening of the CERCLA exemption pursuant to section 101(20)(A) and the Spill Act exemption’s language which provides more detailed guidance than CERCLA. The judicial trend to broadly construe lender exemptions since *Fleet Factors* indicates that lender’s efforts to challenge adverse rulings have begun to bear consistent results.¹¹⁰

V. STATE LAW CLAIMS, PREEMPTION AND THE EPA RULE

A. Common Law Aiding and Abetting Claims: Possible Circumvention of CERCLA Lender Liability Exemption

A related area of environmental exposure was at issue in *Friends of Sakonnet v. Dutra*,¹¹¹ and *O’Neil v. Q.L.C.R.I., Inc.*,¹¹² two federal district court cases from Rhode Island. In *O’Neil*, a citizens’ group and the Attorney General for the State of Rhode Island brought suit against the developers and residents of a housing development, a trust corporation formed to operate and maintain the sewage treatment plant for the development, and two lenders that held mortgages on real property located within the boundaries of the development.¹¹³ The initial complaint sought declaratory, injunctive and monetary relief for violations of the Federal Water Pollution Control Act (“FWPCA”),¹¹⁴ and the tort of common law nuisance.¹¹⁵

In *Sakonnet*, discharges of raw, untreated sewage were pumped from a development directly into the Sakonnet River located in

108. *Id.* at 398.

109. For a further discussion of *Fleet Factors*, see *supra* notes 51-60 and accompanying text.

110. Perhaps more significantly, the Spill Act exemption could be utilized as a workable model for any future Congressional efforts.

111. 738 F. Supp. 623 (D.R.I. 1990).

112. 750 F. Supp. 551 (D.R.I. 1990).

113. *Friends of Sakonnet*, 738 F. Supp. at 627-28 (setting forth background of *O’Neil*).

114. Federal Water Pollution Control Act (“FWPCA”), 62 Stat. 1155 (1948) (codified as amended at 33 U.S.C. §§ 1251-1376 (1993)).

115. *Friends of Sakonnet*, 738 F. Supp. at 627. A plaintiff may recover damages for nuisance in tort from the parties creating the nuisance as well as any successor-in-interest who maintains the nuisance. *Id.* A violation of the FWPCA will result from a discharge of an effluent into navigable waters which causes contamination. See FWPCA, 33 U.S.C. § 1311(a).

Portsmouth, Rhode Island, continuously for twenty years.¹¹⁶ The court held that this was a nuisance per se and that an action under the FWPCA was proper against all parties except the two lenders.¹¹⁷

The *Sakonnet* plaintiffs conceded that the lenders would not be liable unless they foreclosed on their mortgages.¹¹⁸ The plaintiff in *O'Neil* took a very different position, however. In *O'Neil* one of the two lenders, Davisville Credit Union ("Davisville"), brought a motion to dismiss the complaint, contending that the claims against it did not present a justiciable case or controversy because they had not foreclosed on their mortgage.¹¹⁹ The *O'Neil* plaintiff sought declaratory injunctive relief and amended their complaint to include a count against Davisville for aiding and abetting,¹²⁰ contending that Davisville aided in violating the FWPCA and state nuisance law.¹²¹ The court granted the plaintiff's motion to amend, holding that the common law concepts of aiding and abetting advanced the goals of the FWPCA and that the FWPCA did not preempt state claims based on this theory.¹²² While the court agreed that prior to foreclosure the lender could not be held directly liable under the FWPCA and common law nuisance claims, it also held that the plaintiff had alleged sufficient involvement and possible control by the Bank over the development of sewage treatment practices to present a viable claim of aiding and abetting.¹²³ Accordingly, the court rejected Davisville's argument that the FWPCA bars aiding and abetting claims.¹²⁴

116. *Friends of Sakonnet*, 738 F. Supp. at 626.

117. *Id.* at 636.

118. *Id.* at 626, n.3.

119. *O'Neil*, 750 F. Supp. at 553.

120. RESTATEMENT (SECOND) OF TORTS § 876 (1979) provides the standard for aiding and abetting liability: for harm resulting to a third person from the tortious conduct of another, one is subject to liability if he knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other. *Id.*

121. *O'Neil*, 750 F. Supp. at 553-54. The plaintiff sought to use the common law concept of aiding and abetting to find Davisville in violation of federal and state statutory and common law. *Id.* at 554. Plaintiff alleged that Davisville "collaborated in a scheme to lend money to a borrower in the name of another," and that Davisville had "influence and control" over principal polluters because Davisville knew of the contamination and could have conditioned loans on remedying the problem. *Id.*

122. *Id.* at 555 (citing *Petro-Tech, Inc. v. Western Co. of North America*, 824 F.2d 1349 (3d Cir. 1987)). The *O'Neil* court acknowledged that the United States Supreme Court ruled that the FWPCA preempts the federal common law of public nuisance, but stated that it does not necessarily follow that the FWPCA preempts consideration of an aiding and abetting theory. *Id.*

123. *Id.*

124. *Id.*

This opinion is troubling to lenders because it opens the door for lender liability in a fashion similar to *Fleet Factors*. It is potentially more vexing than *Fleet Factors*, however, because courts have broadened the CERCLA section 101(20)(A) exemption, and EPA has promulgated interpretive regulations which state that the "capacity to influence" a debtor's facility is not enough to bring a secured lender under the CERCLA liability provisions.¹²⁵ More problematic is the possible use of aiding and abetting theories by plaintiffs to reach the "deep pockets" of lenders even when they cannot sue a lender for actually violating a pollution act or creating a nuisance.¹²⁶

The *O'Neil* court's opinion takes on special significance because of the SARA amendments, which limited the application of the preemption doctrine in CERCLA actions as enunciated by the United States Supreme Court.¹²⁷ In *Exxon Corp. v. Hunt*,¹²⁸ the Supreme Court held that a tax enacted by the New Jersey legislature for financing the Spill Act was preempted by federal law where the Spill Act and CERCLA overlapped.¹²⁹ This litigation arose when Exxon challenged the funding mechanism for the Spill Act contending that former CERCLA section 114(c) preempted the Spill Act.¹³⁰ While the New Jersey Supreme Court emphasized the repeal of CERCLA section 114(c) by the SARA amendments on remand,¹³¹ the policy implications of allowing common law actions to redress injuries and damages are clear. EPA was allocated more than eight billion dollars for CERCLA cleanup and enforcement actions under the SARA amendments. Congress sought to place EPA in a supervisory role with the ability to respond to emergencies when needed but its primary role was to charge those "responsible" for cleanup costs. While CERCLA and state law liability for cleanup of toxic waste is a problem which should be addressed when considering a loan application or foreclosure on a property, EPA names a

125. See 40 C.F.R. § 300.1100 (1992).

126. See John Voorhees & Robert M. Steele, *Birth of a New Lender Liability Theory? Aiding and Abetting a Borrower's Violation of Environmental Laws*, 6 Toxics L. Rep. (BNA) 950, 954 (1992) (authors comment that aiding and abetting theories bear striking resemblance to *Fleet Factors*' "capacity to influence" test).

127. See *Exxon Corp. v. Hunt*, 475 U.S. 355 (1986).

128. *Id.*

129. *Hunt*, 475 U.S. at 376-77.

130. *Id.* at 358-59.

131. See *Exxon Corp. v. Hunt*, 534 A.2d 1 (N.J. 1987).

small number of lenders as compared to other potentially responsible parties in suits under CERCLA.¹³²

B. EPA Final Rule Defining Lender Liability Under CERCLA

EPA's final regulations defining the secured creditor exemption were promulgated because of the uncertainty stemming from the various cases, including *Fleet Factors*, interpreting section 101(20)(A) of CERCLA.¹³³ The EPA rule defines "indicia of ownership" as those interests in real or personal property held as security or collateral for a loan, including real or personal property acquired in the course of protecting the security interest.¹³⁴ Examples of "security interests" may include, but are not limited to: (1) mortgages, deeds of trust, or legal title obtained pursuant to foreclosure or its equivalence; and (2) assignments, liens, pledges or other rights to or encumbrances against facilities furnished by borrowers as security for loans.¹³⁵

The EPA rule states that a mortgage must be obtained for the purpose of protecting a security interest as opposed to increasing the return on an investment.¹³⁶ It defines the phrase "primarily to protect the security interest," as an ownership interest which represents a true security interest as opposed to a lease or consignment.¹³⁷ To protect a security interest, the lender must focus its activities on repayment of the loan as opposed to enhancement of its investment.¹³⁸ The EPA rule also provides that the secured lender exemption will not apply where a lender acts as a trustee or manager of property or a business or where it acts in a non-lending capacity or as any interest other than one created as a *bona fide* security interest.¹³⁹ Financial workouts and foreclosures followed by

132. The data showed that out of 17,095 potentially responsible parties at more than 1200 superfund sites, only 40 lenders (.2%) of all potentially responsible parties were named. This may change depending on EPA's funding priorities and the fact that EPA was allocated only 10% of the funds estimated at the time the study was conducted to clean up toxic wastes and SARA encourages state, local and private participation in clean-up matters. *Exxon*, 534 A.2d at 9, 11-13 (citing H.R. Rep. No. 253, 99th Cong., 1st Sess. 1, 55 (1985), reprinted in 1986 U.S.S.C.A.N. 1835). *But see* 40 C.F.R. § 300.1100 (final EPA rule on lender liability attempting to clarify lender activity boundaries).

133. *See* 40 C.F.R. § 300.1100 (1992).

134. 40 C.F.R. § 300.1100(a).

135. *Id.* § 300.1100(b)(1), (c)(2), (d).

136. *Id.* § 300.1100(b)(1).

137. *Id.*

138. *Compare* *Kelley v. Tiscornia*, 810 F. Supp. 901 (W.D. Mich. 1993) (mortgage and accounts receivable financing) *with* *Kemp*, 857 F. Supp. at 373 (leaseback financing falls under CERCLA lender exception).

139. 40 C.F.R. § 300.1100(c)(1).

expeditious liquidation of assets are permissible and do not constitute participation in the management of the facility provided that the actions taken are necessary to protect the security interest, as defined under the EPA rule.¹⁴⁰ In EPA's view, a lender is primarily protecting its security interest during a loan workout when it restructures or renegotiates the terms of the loan obligation, requires payment of additional interest, extends the payment period, provides specific financial or operational advice, suggestions, counseling, guidance or any other action reasonably necessary to protect the lender's security interest.¹⁴¹ The regulation provides, however, that the lender's actions must consider and account for hazardous substances known to be present at the facility and must not cause or contribute to the environmental harm.¹⁴² Most importantly, the borrower must remain the ultimate decision maker concerning operations of the facility.¹⁴³ If the lender takes over the decision making or directs an environmental compliance program, they will forfeit the exemption.¹⁴⁴ Equally important is the fact that during the course of a loan workout or foreclosure, EPA specifically rejects the "capacity to influence" test promulgated by *Fleet Factors*, and for purposes of an EPA initiated suit, would not seem to be motivated to pursue lenders who have complied with the rules. Finally, the regulation addresses the innocent landowner defense under CERCLA section 107(b)(3) which provides:

there shall be no liability under § 107(a) for a person who can establish . . . that the release or threat of release of a hazardous substance and the damages resulting therefrom were caused solely by—

(3) an act or omission of a third party other than . . . one whose act or omission occurs in connection with the contractual relationship existing directly or indirectly with the defendant . . . if . . . (a) he [the defendant] exercised due care with respect to the hazardous substance, . . . and (b) he took precautions against

140. *Id.* § 300.1100(c)(2)(ii)(B). In addition, EPA appears to encourage lenders to remediate waste site contamination pursuant to CERCLA section 107(d)(1). *Id.* § 300.1100(d)(3)(ii).

141. *Id.* § 300.1100(c)(2)(U), (B).

142. *Id.* § 300.1100(c)(2)(ii). This provision should raise concerns about the competence of remediation personnel. Lenders must choose wisely when they decide to clean up a site.

143. 40 C.F.R. § 300.1100(c)(2)(ii).

144. *Id.*

foreseeable acts or omissions of any . . . third party
¹⁴⁵

For purposes of the innocent landowner defense, CERCLA provides within the definition of the term "contractual relationship," that if at the time a defendant acquired a facility he did not know and had no reason to know that there were any hazardous substances disposed of at the facility, then liability shall not attach.¹⁴⁶ In order to establish a lack of knowledge under this provision, a defendant must have undertaken all appropriate inquiries into the previous ownership of the property consistent with good commercial business practices or customary practice within the industry in an effort to minimize liability.¹⁴⁷

Unfortunately, the Court of Appeals for the District of Columbia recently vacated the EPA lender rule, declaring that it was for the courts and not EPA to interpret the scope of CERCLA.¹⁴⁸ In *Kelley v. EPA*,¹⁴⁹ the petitioners challenged EPA's ability to regulate the scope of the lender exemption.¹⁵⁰ In deciding that EPA had no interpretive authority regarding the lender liability rule, the court held that while Congress delegated broad administrative power over the statute, it was EPA's burden to demonstrate "either explicit or implicit evidence of congressional intent to delegate interpretive authority."¹⁵¹ The *Kelley* court reasoned that because private parties could sue for contribution independent of actions taken by EPA, courts and not EPA are charged with determining the scope of the liability exemption under CERCLA section 101(20)(A).¹⁵² Thus, the court vacated EPA's rule.¹⁵³

Since to date no further policy statements have been issued, the EPA rule can at best be viewed as only one litigant's opinion

145. CERCLA § 107(b), 42 U.S.C. § 9607(b).

146. CERCLA § 101(35)(A),(B), 42 U.S.C. § 9601(35)(A),(B).

147. *Id.*

148. *See Kelley v. EPA*, 15 F.3d 1100 (D.C. Cir. 1994), *cert. denied*, 115 S. Ct. 900 (1995).

149. 15 F.3d 1110 (D.C. Cir. 1994), *cert. denied*, 115 S. Ct. 900 (1995).

150. *Id.* at 1105. The petitioners, the State of Michigan and the Chemical Manufacturer's Association, stood to benefit from allowing contribution and indemnity actions against lenders. *Id.* at 1104-05.

151. *Id.* at 1105 (citing *Linemaster Switch Corp. v. EPA*, 938 F.2d 1299, 1303 (D.C. Cir. 1991)).

152. *Kelley*, 15 F.3d at 1107; *see also Adams Fruit Co. v. Barrett*, 494 U.S. 638, 650 (1990) (rejecting Department of Labor's authority to adjudicate private rights of action); 126 Cong. Rec. 30,932 (1980) (Sen. Randolph states that liability issues not resolved by act are to be governed by common law).

153. *Kelley*, 15 F.3d at 1109.

(albeit an important one). However, given the expanded application of the lender exemption by the post-*Fleet Factors* decisions, the rule does not bear as much practical importance as it might have otherwise.¹⁵⁴

VI. ENVIRONMENTAL DUE DILIGENCE REQUIREMENTS

There are no universally accepted practices upon which a lender can base its environmental review process. While EPA's rule requires a lender to conduct pre-loan audits as a condition to qualifying for protection under the CERCLA secured lender exemption, and to ensure sound operation of the borrower's facility by correcting any unreasonable environmental practices, these requirements are not specifically incorporated into the statute. The lack of uniform standards is explained, in part, by the fact that EPA does not want to discourage voluntary auditing by promulgating strict standards which may not take into account factors which vary from one industry or organization to the next.¹⁵⁵

Nonetheless, lenders are well advised to consider the results of a due diligence review or environmental audit before taking steps to either approve a loan in the first instance or to foreclose on collateral.¹⁵⁶ It follows, therefore, that when analyzing title search results, a lender should look into any obvious party which could have contaminated the property. When drafting the loan documents, it would be prudent to provide coverage for environmental compliance and indemnity of the lender to fund a cleanup. Finally, when foreclosing, a lender should gather as much information as it feels necessary to determine whether a waste problem exists. For a residence, this may entail simply reviewing the title search and driving by the property to identify any obvious hazards.¹⁵⁷

An industrial property search will generally entail a more thorough analysis. A buyer should be sought out and lined up ahead of time whenever possible. Moreover, a clean-up plan should be contemplated and cooperation with government officials considered.

154. For a thorough analysis of EPA's ability to promulgate the lender exemption in light of Supreme Court rulings, see Note, James S. Flood, *EPA's Interpretive Rule on CERCLA § 101(20)(A): Does it Create a Safe Harbor For Secured Lenders?*, 24 RUTGERS L.J. 511, 515-16 & n.33 (1993).

155. Environmental Auditing Policy Statement, 51 Fed. Reg. 25,004, 25,007 (1986) [hereinafter Auditing Policy Statement].

156. *Id.*

157. For a discussion of the specific environmental problems residential lenders are likely to encounter, see generally Sharp, *supra* note 76 and accompanying text, regarding specific environmental problems which residential lenders are likely to encounter.

EPA policy takes into account on a case-by-case basis the "honest and genuine efforts" of entities to avoid and promptly correct violations and underlying environmental problems, particularly when the entity was not required to report or record the problem.¹⁵⁸ In addition, courts have been less prone to impose liability on lenders who: (1) transfer property quickly; and (2) attempt to aid rather than hinder waste removal activities.¹⁵⁹ Both a due diligence review and an environmental audit cover the issue of hazardous chemical contamination on a site. The due diligence review is normally conducted as part of a real estate transaction.¹⁶⁰ Environmental audits, on the other hand, are conducted to evaluate compliance with environmental laws in order to bring site management practices into line with environmental laws for purposes of minimizing risk, insuring the property, and other nontransactional reasons.¹⁶¹

Sales of residential property from foreclosure may require more care given the consumer nature of the transaction.¹⁶² A lender selling property to consumers who have little sophistication in the environmental area has a duty to disclose latent environmental defects.¹⁶³ The Federal National Mortgage Association ("FNMA") provides a set of guidelines for a lender when selling mortgages to FNMA in the secondary mortgage market. The first type of analysis is called a Phase I Assessment, which involves review of records including title searches, permits issued by state and federal environmental agencies, zoning restrictions or special uses, and lender file reviews.¹⁶⁴

Most state environmental laws are concerned with industrial rather than residential property. Following their requirements will alert a lender to potential state law risks.¹⁶⁵ A site inspection, however, is also recommended for a residential property because: (1) an owner may be conducting illegal waste storage practices; (2) the land in question may have unusual characteristics such as being adjacent to a body of water indicating possible run-off problems; or

158. Auditing Policy Statement, *supra* note 155, at 25,007.

159. For a discussion of caselaw addressing lender liability, see *supra* notes 16-88, and accompanying text.

160. Sharp, *supra* note 76, at 240.

161. NICHOLAS A. ROBINSON, ENVIRONMENTAL REGULATION OF REAL PROPERTY §§ 25.02, 25-33 (REV. NOV. 9, 1990).

162. Sharp, *supra* note 75.

163. *Id.*

164. See ROBINSON, *supra* note 161, §§ 25-33.

165. See, e.g., N.J. STAT. ANN. §§ 13:1k-6 -1k-13; (sale of industrial real property requires registration with and approval by state Department of Environmental Protection and Energy).

(3) there may be an adjacent property with potential hazards which could effect the property in question.¹⁶⁶ Ideally, the lender will have the cooperation of the site owner when physically inspecting the property. Even if cooperation is not attainable in a given situation, the lender's agent can still detect any unusual odors or discoloration of the soil or other unusual physical characteristics by performing a drive-by search.¹⁶⁷ Other possible alternatives to a site inspection include checking with local authorities for complaints by neighbors, looking for surface and underground fuel storage tanks or nearby electrical transformers, and locating sanitary and other discharge pipes in the immediate area.

While expert participation in the Phase I review is recommended, an experienced loan officer or attorney is also capable of gathering the documentation and doing the site inspection necessary for purposes of discovering Phase I environmental problems. If questions are raised regarding a particular hazard, or uncertainty develops after checking with local, state and federal authorities and reviewing records concerning the property, a Phase II assessment should be performed.¹⁶⁸ In addition, EPA suggests that the following elements are necessary to effectuate an internal auditing procedure:

- I. Explicit top management support for environmental auditing and commitment to follow-up on audit findings.
. . . .
- II. An environmental auditing function independent of audited activities. . . .
- III. Adequate team staffing and auditor training. . . .
- IV. Explicit audit program objectives, scope, resources and frequency. . . .
. . . .
- V. A process which collects, analyzes, interprets and documents information sufficient to achieve audit objectives. . . .

166. ROBINSON, *supra* note 161, at §§ 25-33.

167. *Id.*

168. While there is no single standard for environmental evaluation of real property, the Federal National Mortgage Association Multi-Family Environmental Hazard Procedure Guidelines shed some light on the topic. The guidelines are used by FNMA when purchasing mortgages in the secondary mortgage market. These guidelines do not provide an answer to the environmental evaluation problem, but they do give a lender an indication of certain questions to ask, and, depending on the type of property involved, whether or not an environmental consultant should be retained to evaluate a given property.

. . . .

VI. A process which includes specific procedures to promptly prepare candid, clear and appropriate written reports on audit findings, corrective actions, and schedules for implementation. . . .

VII. A process which includes quality assurance procedures to assure the accuracy and thoroughness of environmental audits. . . .¹⁶⁹

Finally, it is recommended that an attorney oversee the environmental evaluation process in order to shield the information from public scrutiny with the attorney-client privilege.¹⁷⁰

VII. CONCLUSION

CERCLA was enacted 15 years ago to facilitate cleanup of toxic waste sites. Congress, noting that lenders had little or nothing to do with contaminating real property, attempted to carve an exception to the remedial legislation by enacting section 101(20)(A) of CERCLA. While manufacturers and other groups have utilized CERCLA and other laws to draw lenders into the environmental litigation quagmire, recently the courts have begun to enforce the original spirit of the lender exemption.

The broadening of the lender exemption has been incremental at best. This author hopes that the liability loopholes are closed. Unless a lender itself is directly responsible for the contamination, there is no sound basis to hold them liable for pollution caused by other parties. Moreover, lenders should be encouraged to make loans to facilitate economic growth. Any further narrowing of CERCLA section 101(20)(A) will not solve the underlying problem of 100 years of improper waste disposal practices. If lenders inject less money into the economy, fewer businesses will have fewer dollars to spend on cleaning up the environment.

169. Auditing Policy Statement, *supra* note 155, at 25,009 (Appendix).

170. *Id.*

