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The Environmental Due Diligence Defense and Contractual Protection Devices

In the last decade, potential liability for environmental contamination has grown tremendously, affecting parties not normally involved in the generation, treatment, storage, disposal, or transportation of hazardous wastes. Financial lenders have been held liable, as have purchasers, lessors, lessees, shareholders who are also officers of a corporation, and other parties involved in transactions involving immovable property. Because of this potential liability, virtually every transaction involving real property carries some risk of environmental liability. Recognizing the danger, parties to these types of transactions are attempting to protect themselves in a variety of ways.

Protection devices can be found in two general areas. The first device is the "third party defense," which allows innocent parties who acquire property to avoid liability for the cost of response. The other method of protection is contractual; parties can draft provisions which regulate their rights and responsibilities in a transaction involving environmental risk. Both of these areas of protection should be explored in order to be afforded the maximum protection.

This comment examines the types of environmental risks arising in real estate transactions and offers some suggestions for avoiding those risks. Section I reviews the statutory and jurisprudential sources of liability for environmental contamination. Section II explores these environmental risks from the perspectives of the various parties involved in such transactions. Finally, section III examines the available protection devices with particular emphasis placed on the due diligence inquiry under the third party defense.

Statutory Jungle

While many state and federal statutes provide for environmental regulation and liability, two federal statutes serve to define the primary risks related to immovable property transactions. The Resource Conservation and Recovery Act (RCRA) regulates the management of hazardous waste from generation to disposal. The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) provides the federal government with the authority to clean up existing

hazardous waste sites and imposes liability upon those legally responsible for the costs of response.

*Resource Conservation and Recovery Act (RCRA)*¹

RCRA is primarily intended to prevent the creation of new hazardous waste sites. It achieves this goal by regulating not only disposal facilities,² but also generators³ and transporters⁴ of hazardous waste. RCRA's primary regulatory mechanism is a manifest system, which requires every party handling hazardous wastes to trace the waste from generation to disposal.⁵ Beyond this, RCRA imposes more specific requirements on each class of hazardous waste handler.

Owners and operators of hazardous waste treatment, storage, and disposal (TSD) facilities must comply with detailed and complex regulations under RCRA.⁶ Records must be maintained as to all hazardous waste treated, stored, or disposed of in the facility, and all reporting and monitoring must be done within the manifest system. The regulations also establish detailed technical requirements with respect to treatment, storage, or disposal practices, construction of TSD facilities, and training of personnel. Finally, every TSD facility must comply with the specific requirements of its permit.⁷

The EPA regulations under RCRA defines a generator as "any person, . . . whose act or process produces hazardous waste identified or listed [as hazardous] or whose act first causes hazardous waste to become subject to regulation."⁸ The regulations originally excluded small quantity generators, but today most are subject to similar, though less stringent, requirements.⁹ Basically, a generator must identify and label hazardous wastes and furnish information about their chemical composition to those transporting, storing, treating, or disposing of the waste. In addition, the generator is the first step in the manifest system and must be able to track the waste to a TSD facility.¹⁰

1. 42 U.S.C.A. §§ 6901-91 (West Supp. 1988).

2. *Id.* at § 6924.

3. *Id.* at § 6922.

4. *Id.* at § 6923.

5. *Id.* at § 6903(12).

6. 40 C.F.R. § 264 (1988).

7. U.S.C.A. § 6925 (West Supp. 1988), provides that every TSD facility must obtain a permit under RCRA, or qualify as an "interim status" facility.

8. 40 C.F.R. § 260.10 (1988) (the term is not generically defined in the statute itself).

9. C.F.R. § 260.10 (1988); generators producing less than one hundred kilograms of hazardous waste per month are generally not subject to RCRA regulation, 42 U.S.C.A. § 6921(d).

10. 42 U.S.C.A. § 6922 (West Supp. 1988).

A transporter is defined under the regulations as anyone "engaged in the offsite transportation of hazardous waste by air, rail, highway, or water."¹¹ Basically, a transporter is responsible for complying with extensive reporting requirements in the event of a release during transportation.¹² In addition, a transporter perpetuates the manifest system by retaining copies for at least three (3) years and refusing to accept hazardous waste without the appropriate manifest.¹³

The Act provides for both civil and criminal penalties for violations, including injunctive relief.¹⁴ Anyone who intentionally fails to comply with any of the Act's requirements is subject to criminal sanctions of a maximum of two years imprisonment and fines up to fifty thousand dollars.¹⁵ If a violator has knowledge that the violation may place another in imminent danger of serious bodily harm, the criminal sanctions increase to fifteen years imprisonment and two hundred and fifty thousand dollars. If the violator is a corporation, the maximum fine increases to one million dollars.¹⁶ If the violation was not intentional, the violator faces civil penalties of up to twenty five thousand dollars per day.¹⁷

*Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)*¹⁸

CERCLA is a remedial rather than a regulatory statute. It was hurriedly passed as a compromise in the waning years of the Carter Administration, primarily to deal with sites such as the Love Canal, which were so dangerous that immediate clean up action was required. It is most often used to deal with inactive, abandoned, or illegal hazardous waste sites, although it should also apply to existing facilities.¹⁹

CERCLA authorizes the EPA to arrange for the removal of dangerous substances from waste sites, or to take any other action consistent with the national contingency plan whenever there is a release or threatened release of any hazardous substances presenting a danger to the

11. 40 C.F.R. § 260.10 (1988) (the term is not defined in the statute itself). A transporter who stores hazardous waste for more than ten (10) days becomes an "operator" of a TSD facility and must comply with those regulations as well. 40 C.F.R. § 263.12 (1988).

12. 40 C.F.R. § 263.30-.31 (1988).

13. 40 C.F.R. § 263.20-.22 (1988).

14. 42 U.S.C.A. § 6928(a) (West Supp. 1988).

15. 42 U.S.C.A. § 6928(d) (West Supp. 1988).

16. *Id.* at § 6928(e).

17. *Id.* at § 6928(a)(3), (g).

18. 42 U.S.C.A. §§ 9601-75 (West Supp. 1988). Louisiana hazardous waste provisions can be found in La. R.S. 30:2171-2206 (1989).

19. Note, Federal Preemption of State Law Environmental Remedies After *International Paper Co. v. Ouellette*, 49 La. L. Rev. 193, 210-13 (1988).

public health.²⁰ If necessary, these response actions can be funded by "Superfund," a fund established by CERCLA to provide the government with the financial resources to respond to a hazardous waste release.²¹ The primary costs of response, however, are to be borne by private "responsible parties."

To abate the danger presented by the waste site, the EPA can proceed in a number of ways. It can undertake the response action itself using the Superfund and later seek reimbursement from those responsible for the site.²² However, such a course of action increases the financial risk on the Superfund in the event of the insolvency of one or more of the responsible parties. Therefore, it is usually preferable to obtain injunctive relief against the responsible parties, or to issue an administrative order to a potentially responsible party to begin a private response action.²³

The Act can have far reaching effects for a potentially responsible party, which may include a current owner or operator, an owner or operator at the time the waste was deposited, a generator, or a transporter of hazardous wastes.²⁴ The liability of lenders, purchasers, lessors and lessees usually occurs under "owner or operator" status.

Section 101 of the Act defines the term "owner or operator" broadly. Generally, it includes anyone who has owned or otherwise controlled the activity of the releasing facility.²⁵ However, the Act excludes from the definition "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."²⁶ The security interest exclusion presents two important issues. The first concerns the level of activity of the lender which would constitute participation in the management of the borrower's vessel or facility. The second issue concerns whether a lender that forecloses on its collateral holds indicia of ownership primarily to protect its security interest.

The issue of the lender's participation in management was discussed in the case of *United States v. Mirabile*.²⁷ The most important element of *Mirabile* dealt with the bank's participation in the activities of the

20. 42 U.S.C.A. § 9604(a)(1) (West Supp. 1988). The National contingency plan is published by the EPA under 42 U.S.C.A. § 9605 (West Supp. 1988), and contains the plan for removal of oil and hazardous substances.

21. "Superfund" refers to the fund established by CERCLA to provide the government with the financial resources to respond to a hazardous waste release, 42 U.S.C. § 9631 (1983).

22. *Id.*

23. 42 U.S.C. § 9606(a) (1983).

24. 42 U.S.C.A. § 9607(a) (West Supp. 1988).

25. 42 U.S.C.A. § 9601(20)(A) (West Supp. 1988).

26. *Id.*

27. 15 *Envtl. L. Rep. (Envtl. L. Inst.)* 20994 (E.D. Pa. 1985).

borrower, which could destroy the exclusion even if the bank intended to act merely to protect its security interest. The district court held that American Bank qualified for the exemption because it had not become "overly entangled" in the borrower's hazardous waste activities. The same conclusion could not be reached, however, for a second lender, Mellon Bank.

Mellon's predecessor held a security interest in the inventory and assets of Turco Coatings, a paint manufacturer. When Turco began experiencing financial difficulties, the bank became involved in the company's operations. An officer of the bank served on an advisory board overseeing Turco's operations, while another officer monitored the company's financial condition. As Turco's financial situation worsened, the bank's involvement grew to include weekly visits and instructions concerning personnel and manufacturing. Turco ceased operations and the bank seized its inventory, but did not acquire title to the property.

Reviewing section 101(20)(A), the court determined that the participation in the management of the borrower must occur in connection with the "facility" in order to destroy the exclusion. "Facility" is defined in section (101)(9) of the Act to include the structure or site where hazardous substances are located.²⁸ Thus, the court concluded that a secured party would lose the exclusion only if it participated in the actual *operation* of the facility, not merely participate in the borrower's *financial* decisions. The issue of whether Mellon participated in the actual operation of the facility was reserved for the presentation of further evidence at trial, but the parties settled. Today, the level of participation in the borrower's activities that would destroy the exclusion is still open to question.

The issue of whether foreclosure on the property destroys the exclusion was faced by the United States District Court in Maryland in *United States v. Maryland Bank & Trust Co.*²⁹ In this case, Maryland Bank had loaned money for the operation of two garbage businesses at a site in which the bank held a security interest. When the borrower defaulted, the bank instituted foreclosure proceedings and purchased the property at the foreclosure sale. The bank continued to own the property when the EPA discovered improperly disposed wastes more than one year later. The wastes had been deposited before the bank foreclosed on the property. When the EPA ordered Maryland Bank to conduct a clean up, the bank refused, forcing the EPA to conduct the clean up itself.

The United States brought suit demanding that Maryland Bank reimburse the Superfund for over \$500,000.00 of response costs. The

28. 42 U.S.C.A. § 9601(9) (West Supp. 1988).

29. 632 F. Supp. 573 (D. Md. 1986).

government argued that a current owner is liable for response costs regardless of fault.³⁰ The bank contended that it was not an "owner or operator" as those terms are defined in section 101(20)(A), since it held indicia of ownership merely to protect its security interest in the facility.

On a motion for summary judgment, the court rejected the argument that Maryland Bank was exempted from the definition of owner or operator because it was merely protecting its security interest. It reasoned that the verb tense used in the exclusion exempted only one who "holds" the security interest at the time of the clean up. Since the mortgage held by the bank terminated at the foreclosure sale when the bank acquired full title, the bank was not entitled to the exclusion.³¹ Thus, Maryland Bank was an "owner" and was strictly liable without regard to causation.³²

This issue was also addressed in the earlier case of *United States v. Mirabile*.³³ But in contrast to the position taken in *Maryland Bank*, the *Mirabile* court held that American Bank, which foreclosed and held title for only four months before assigning its interest, acted to protect its security interest and was, therefore, exempt as an owner under section 101(20)(A).³⁴ The *Maryland Bank* court attempted to distinguish this aspect of *Mirabile* due to the short time that American Bank held title, but specifically disagreed with the holding to the extent that it could not be distinguished.³⁵

In addition to the security interest exemption, CERCLA also provides a limited defense for an owner or operator. If the owner or operator can prove that the act or omission causing the release was solely the fault of a third party, and he can also establish that he exercised due care once the presence of the hazardous substances was discovered, the owner or operator is not liable.³⁶ However, a "third party" does not include "an employee or agent of the defendant, or . . . one whose act or omission occurs in connection with a contractual relationship, existing directly or indirectly, with the defendant . . ."³⁷

The court in *Maryland Bank* remanded for trial the issues raised by this defense. It refused to preclude Maryland Bank from raising the defense due to its lengthy business relationship with the owners of the

30. See *New York v. Shore Realty Corp.*, 759 F.2d 1032 (2d Cir. 1985) (Present owners are liable even though they had not contributed to the contamination).

31. *Maryland Bank*, 632 F. Supp. at 579.

32. *Id.* at 578, citing *Shore Realty*, *supra* note 30.

33. 15 *Env'tl. L. Rep. (Env'tl. L. Inst.)* 20994 (E.D. Pa. 1985).

34. 15 *Env'tl. L. Rep. (Env'tl. L. Inst.)* 20994, 20966 (E.D. Pa. 1985).

35. *Maryland Bank*, 632 F. Supp. at 580.

36. 42 U.S.C. § 9607(b)(3) (1983).

37. *Id.*

waste site. Instead, it requested more evidence as to the status of the relationship at the time the dumping occurred. Specifically, the court inquired into the existence of any outstanding loans during the time of the operations which caused the contamination.³⁸ This suggests that the mere existence of an outstanding loan during the disposal period could be enough to preclude the application of the third party defense when the mortgagee becomes the owner because of the contractual relationship between mortgagee and mortgagor. However, Maryland Bank also settled before this issue came to trial.

The Superfund Amendments and Reauthorization Act of 1986 (SARA) attempted to clarify this defense by defining the term "contractual relationship."³⁹ Section 101(35) of CERCLA now provides that the term does not include a defendant who acquired the property after the disposal of the wastes if the defendant can show, by a preponderance of the evidence, that at the time of acquisition it neither knew nor had any reason to know of the presence of hazardous wastes on the property. The definition also requires the defendant to satisfy sections 107(b)(3)(a) and (b), which require it to exercise due care and to take proper precautions after the wastes are discovered.⁴⁰ In addition, the definition attempts to provide some guidance to the courts by enumerating the factors that a defendant must establish in proving that it had "no reason to know:"

"... the defendant must have undertaken, at the time of acquisition, all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice in an effort to minimize liability. For purposes of the preceding sentence the court shall take into account any specialized knowledge or experience on the part of the defendant, the relationship of the purchase price to the value of the property if uncontaminated, commonly known or reasonably ascertainable information about the property, the obviousness of the presence or likely presence of contamination at the property, and the ability to detect such contamination by appropriate inspection."⁴¹

Finally, the section requires any owner who discovers the presence of hazardous wastes during his period of ownership to disclose that fact

38. *Maryland Bank*, 632 F. Supp. at 581.

39. 42 U.S.C.A. § 9601(35)(A) (West Supp. 1988).

40. *Id.* at § 9607(b)(3)(a) and (b). See also H.R. 99-253(v), 97th Cong., 2d Sess. 4(1986); 1986 U.S. Code Cong. and Admin. News 3124, 3280 (imposes "due care which is reasonable under the circumstances" standard once discover presence of waste. This includes steps taken to protect the public from the threat).

41. 42 U.S.C.A. § 9601(35)(B) (West Supp. 1988).

to subsequent owners. If he fails to do so, he is liable under CERCLA and may not claim the section 107(b)(3) defense.⁴²

SARA also allows the EPA to impose a conventional lien against property when the clean up was financed with the Superfund. However, this lien primes other rights against the land only from the time of recordation.⁴³ The majority of state environmental liens operate the same way. In Louisiana, the Secretary of the Department of Environmental Quality may file a declaration of abandonment in the mortgage records of the parish where the property is located. From the date of recordation, the declaration operates as a lien to the extent of state expenditures on the response action. However, an owner of the site may file an action to have the lien erased if the owner can show he "in no way caused by any action or negligence" the contamination of the site.⁴⁴

Outside of Louisiana, the lender or other lienholder must be aware of potential state "superlien" statutes, such as those enacted in Connecticut,⁴⁵ Massachusetts,⁴⁶ and New Jersey.⁴⁷ These liens receive priority over encumbrances recorded after the effective date of the statute even though the clean up itself occurred after such recordation. Other states have even more stringent lien statutes, and the parties to every transaction involving environmental risk should take care in examining the laws of the state where the property is located.⁴⁸

Beyond liability for clean-up costs, CERCLA also establishes an administrative civil penalty system, divided by classes. The EPA may impose Class I Administrative Penalties upon anyone who violated reporting or record keeping requirements, or orders relating to settlement agreements, or consent decrees.⁴⁹ Class II Administrative Penalties may be assessed for the same violations.⁵⁰ The difference between the two classes is merely the types of penalties assessed. Class I penalties may be up to \$25,000 per violation, while Class II penalties may be up to \$25,000 per day. If the same violations are repeated, these penalties may increase to \$75,000 per day. Criminal penalties for notice, record keeping, and false reporting violations may reach up to five years imprisonment.⁵¹

42. *Id.* at § 9601(35)(C) (sometimes referred to as the "innocent landowner defense" or "third party defense").

43. *Id.* at § 9607(l)(3).

44. La. R.S. § 30:2225(F) (1989).

45. Conn. Gen. Stat. Ann. § 22a-452a (West Supp. 1988).

46. Mass. Gen. L. ch. 21 E. § 13 (1988).

47. N.J. Stat. Ann. § 58:10-23.11 (West 1988).

48. Bozarth, *Environmental Liens and Title Insurance*, 1989 *Law. Title News* (Jan.-Feb.) 19.

49. 42 U.S.C.A. § 9609(a) (West Supp. 1988).

50. *Id.* at § 9609(b).

51. *Id.* at 9603(b)(3).

These statutory and jurisprudential developments under CERCLA have affected not only lenders, but other parties as well. "Owner or operator" has been held to include present owners who did not contribute to the pollution of the site;⁵² former owners as sellers;⁵³ a firm who acted as a conduit for a transfer, holding title for only one hour;⁵⁴ an owner/lessor whose lessee caused contamination of the site;⁵⁵ a lessee who caused contamination;⁵⁶ a sublessor for contamination caused by his sublessee;⁵⁷ and a Vice President and major shareholder responsible for wastes disposed of by his corporation.⁵⁸ These classes of defendants share many of the same concerns, particularly those relating to ownership. To that extent, the concerns and techniques being developed by lenders are applicable to all classes of owners. However, each class of potential owners or operators has some concerns and protection techniques not inimical to the other classes. To this extent, the perspectives of lenders, purchasers, lessors and lessees are analyzed separately.

Nature of the Risks Involved

The Lender's Perspective

The costs of compliance with a broad regulatory statute such as RCRA can be burdensome. Moreover, the costs of noncompliance can be even more substantial given the extent of civil and criminal penalties available to the EPA. This may seriously affect the solvency of the borrower, especially as a greater number of small generators become subject to the requirements of the Act. Lenders should factor these costs into the decision to extend credit.⁵⁹

Another problem is the failure of either RCRA or its implementing regulations to define the terms "owner" or "operator" with sufficient specificity.⁶⁰ RCRA offers no exclusion for a person who holds indicia

52. *New York v. Shore Realty Corp.*, 759 F.2d 1032 (2d Cir. 1985).

53. *Jones v. Inmont Corp.*, 584 F. Supp. 1425 (S.D. Ohio 1984).

54. *United States v. Carolawn Co.*, 14 *Envtl. L. Rep.* (Envtl. L. Inst.) 20699 (D.S.C. 1984).

55. *United States v. Argent Corp.*, 14 *Envtl. L. Rep.* (Envtl. L. Inst.) 20616 (D.N.M. 1984).

56. *United States v. South Carolina Recycling and Disposal, Inc.*, 21 *Envtl. Rep. Cas.* 1577 (D.S.C. 1984).

57. *Id.*

58. *United States v. Northeastern Pharmaceutical and Chemical Co.*, 579 F. Supp. 823 (W.D. Mo. 1984); see also *New York v. Shore Realty Corp.*, 759 F.2d 1032, 1052 (2d Cir. 1985).

59. King, *Lender's Liability For Cleanup Costs*, 18 *Envtl. L.* 241, 250 (1988).

60. *Id.* at 251-252. "Owner" is defined in the regulations as "the person who owns a facility or a part of a facility," while "operator" is defined as "the person responsible for the overall operation of the facility." 40 C.F.R. § 260.10 (1988).

of ownership to protect a security interest. Thus, a lender who takes title may be liable as an owner or operator who contributed to the past or present handling of hazardous waste, which could make the lender subject to RCRA enforcement actions and penalties. There is no guarantee that a CERCLA-like exclusion for a lender protecting its security interest will be read into RCRA by the courts.⁶¹

The greatest potential for lender liability, however, arises under CERCLA. After the *Mirabile* and *Maryland Bank* decisions, it is clear that a lender can become liable as an owner or operator both during and after the loan period.⁶² During the loan, the borrower may begin to experience financial trouble, triggering the lender's temptation to become involved in the management of the borrower's business in order to prevent it from defaulting on the loan. The *Mirabile* court suggested that the lender could become involved in the financial decisions of the borrower without incurring liability, but could not become involved in the actual operation of the facility.⁶³ This position is consistent with section 101(20), which provides that a person may be excluded from the definition of "owner or operator" only if he did not participate in the management of a facility, but allows one to protect his security interest in the facility by holding indicia of ownership. Thus, the Act itself appears to differentiate between the purely financial aspect of management and the operational aspect of management.

This argument was recently embraced by a federal district court in Georgia. In *United States v. Fleet Factors Corp.*,⁶⁴ a lender had a security interest in the borrower's inventory, accounts receivable, equipment, and realty. As the borrower became financially troubled, the lender began "wind-down" operations, which included seizing and selling some of the borrower's inventory. The borrower went into bankruptcy, but the lender continued to finance the borrower as a debtor-in-possession. Finally, when the lender cut off financing, the borrower ceased operations. Upon the final liquidation of inventory, the lender continued to check the credit of customers of the borrower, as was its practice. The funds generated through these sales went to the lender as partial payment. Eventually, the lender foreclosed on the remaining inventory and equip-

61. King, *supra* note 59, at 252.

62. Recently, a bill was introduced in the Congress that would remove "commercial lending institutions" from the definition of "owner or operator" when such institutions take title to foreclosed property or when they acquire contaminated realty in the capacity of a trustee for an estate (HR 2085). This bill, if passed, would protect lenders in most cases from environmental liability under Superfund, and thus remove the necessity of conducting a due diligence inquiry. See 3 *Toxics L. Rep.* 1576.

63. *United States v. Mirabile*, 15 *Envtl. L. Rep.* (Envtl. L. Inst.) 20994, 20997 (E.D. Pa. 1985).

64. No. CV687-070 (S.D. Ga. Dec. 22, 1988).

ment and sold it, contracting with a firm to remove all equipment and inventory not yet removed by the purchasers. At no time did the lender foreclose on the realty.

The EPA later discovered 700 drums of toxic chemicals and asbestos throughout the plant. The United States sued the lender as an "owner or operator," stating that it went "far beyond merely protecting its security interest." The district court held that the lender was not an owner or operator because it had no control or access, nor had it engaged in any other activities at the facility. The court stated that lenders could provide financial assistance and even "isolated instances of specific management advice," as long as the lender did not participate in day to day management of the facility.⁶⁵ Because the activities of the lender were consistent with the protection of its security interest, and the lender did not take title to the property, the court's decision appears correct.

If the borrower defaults, the lender may foreclose on the facility and have it sold to recoup the outstanding loan balance. Most often, the lender will have to take title to the facility, either through a dation en paiement or by purchasing it at the foreclosure sale if no other buyers are available. In either case, the *Maryland Bank* decision presents a substantial risk of liability to the lender. As owner, the former lender may be liable for response costs under CERCLA without regard to causation. While the length of time the former lender holds title to the property may prove to be a relevant factor in the future, there is strong language in *Maryland Bank* to suggest that the lender may become liable as soon as title passes.⁶⁶ In order to protect itself as an "owner," the lender would then have to assert the third party defense. Given the limited governmental funds available for response actions, it is likely that the courts will follow *Maryland Bank* and hold that the lender may be liable as an owner as soon as title passes, unless it can avail itself of the third party defense. Such a result provides a possible "deep pocket" in the form of a potentially responsible party unless the lender comes forward with proof that he acted without knowledge or control over the contamination of the site.

The penalty provisions of CERCLA present problems similar to those encountered under RCRA. If the borrower is assessed with non-compliance penalties, his solvency may become tenuous, even if the

65. At this time, an appeal is pending before the Eleventh Circuit.

66. *Mirabile*, 15 Env'tl. L. Rep. at 20996, held that a lender who held title for only four months was merely protecting its security interest. While *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573, 579 (D. Md. 1986), suggested that this carried some weight, it specifically held that the Bank's security interest terminated when it obtained full title, and it therefore, could not have acted to protect its security interest.

environmental problems arise on a property unrelated to the loan.⁶⁷ Furthermore, if the property is located in a state with a superlien statute, the secured lender may lose its priority even over uncontaminated property.⁶⁸ These factors must be considered in the decision to make or reject the loan.

Another serious problem for lenders is the devaluation of property pledged as collateral, either because of contamination on the property itself, or on neighboring properties. If the collateral itself has been contaminated, the stigma attached to it may make it unmarketable, even if the property was cleaned up or no clean-up was required.⁶⁹ If the collateral is simply in close proximity to a contaminated site or a site presenting an environmental risk, neighboring property values are also likely to be impaired.⁷⁰ In addition, environmental superliens could attach which would prime pre-existing liens and further devalue the property.⁷¹ Lenders should be sure that these environmental factors are being considered in their appraisal of the potential collateral. When appraised in light of these factors, many properties will have a negative value.

The above discussion indicates that lenders should carefully investigate every loan transaction to avoid environmental risk. The existence of the third party defense provides some protection, but in order to claim the defense, the lender's investigation must conform to the developing doctrine of environmental due diligence. To a large extent, this removes the decision making process from the hands of the loan officer and places it in the hands of the lawyer, who must assess the legal risk associated with the proposed transaction. Decisions must now be made not only with regard to the soundness of the collateral and the solvency of the borrower, but also with regard to the rather amorphous concept of environmental due diligence.

SARA's definition of "contractual relationship" gave life to what was in practice a narrow third party defense. As the *Maryland Bank* court suggested, the mere existence of a borrower-lender relationship during the contamination of the site could have destroyed the defense.⁷² Now, however, a bank in the same position would have a defense,

67. King, *supra* note 59, at 265. See also Note, *Cleaning Up in Bankruptcy: Curbing Abuse of the Federal Bankruptcy Code by Industrial Polluters*, 85 *Columbia L. Rev.* 870-871, n.14 (1985), suggesting that increases in bankruptcies by firms operating hazardous waste sites indicate that such companies are routinely undercapitalized.

68. King, *supra* note 59, at 265.

69. Miller and Bennett, *Due Diligence Techniques For the Innocent Purchase/Lender*, 3 *Toxics L. Rep.* 434 (1988).

70. *Id.* at 435.

71. Murphy, *The Impact of "Superfund" and Other Environmental Statutes on Commercial Lending and Investment Activities*, 41 *Bus. Law.* 1133, 1152 (1986).

72. See *supra* note 35 and accompanying text.

notwithstanding the contractual relationship, if it could show it neither knew nor had any reason to know of the presence of the wastes at the time of acquisition.⁷³

The requirement that the lender have "no reason to know" of the presence of the wastes appears to establish a constructive knowledge standard. It is clear that there is a subjective element—the lender must not have known of the wastes. There is also an objective element, but the court is not free to apply any factors it deems relevant. Rather, the inquiry is specifically limited by statutory terms such as "good commercial and customary practices," and "specialized knowledge," as well as by other factors.⁷⁴

Beyond liability risks, there is an additional reason to conduct the environmental investigation in conformity with the due diligence defense. The secondary mortgage market has recognized the environmental risk and has begun to formulate policies and conditions to be met before purchasing mortgages.⁷⁵ Since lenders will have to conform to these conditions before selling the loans, there is a great chance that the policies of the secondary markets will influence "good commercial practices" and other statutory terms defining the objective element of the due diligence defense. For this reason, the policies of the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and other secondary market institutions are particularly relevant when analyzing the appropriate level of inquiry in a given fact pattern involving a lender.⁷⁶

The Purchaser's Perspective

Purchasers of real property share many of the same concerns as lenders. Specifically, purchasers are concerned with their obvious status as "owners" under CERCLA. When a purchaser acquires title to the property, he is a "current owner or operator" and is thus liable without regard to causation.⁷⁷ For this reason, every purchaser of immovable property must be prepared to meet the third party defense.

However, the nature of the problem is somewhat less complicated for purchasers. They are acquiring an interest in the property now, not sometime in the future. Therefore, they do not have to be concerned

73. See *supra* note 36 and accompanying text.

74. 42 U.S.C.A. § 9601(35)(B) (West Supp. 1988). *United States v. Serafini*, 706 F. Supp. 346 (M.D. Pa. 1988).

75. Miller and Bennett, *Environmental Risk: Are Your Loans Marketable?*, 3 *Toxics L. Rep.* 618 (1988).

76. Discussed more thoroughly in section entitled "Protection Devices," *infra* notes 81-130 and accompanying text.

77. *New York v. Shore Realty*, 759 F.2d 1032 (2d Cir. 1985).

with contamination during the loan period, as do lenders. Furthermore, what is "good commercial practice" will depend on the sophistication or "specialized knowledge" of the purchaser. Lenders, on the other hand, will probably be held to a more uniform, industry-wide standard. The concerns of lenders, however, are equally applicable to purchasers, at least to the extent that lenders are concerned with ownership of contaminated property.

The Perspective of Lessees and Lessors

The majority of problems involving contaminated real property will likely involve tenants.⁷⁸ Unlike purchasers, the landlord and the tenant are bound to continue the relationship after the wastes are discovered, unless the agreement contemplated otherwise. Because both the lessor and the lessee are potentially responsible parties under CERCLA, the parties should consider environmental risks when negotiating the lease.

The lessee will be concerned that it might become liable for prior contamination of the site, or for contamination concurrently caused by the lessor or a third party. Because the lessee controls the property, he stands in the shoes of the owner, and is liable under CERCLA on that basis for any contamination occurring during his lease.⁷⁹ As for prior contamination, the lessee should not be liable as an owner or operator because the element of control is lacking and the lessee does not hold title to the property. In this situation, the lessee will primarily be concerned with proving that the contamination was caused prior to his possession of the property. To do this, he may wish to conduct a due diligence inquiry similar to that done by defendants hoping to claim the third party defense.

Lessors, on the other hand, are concerned that the lessee might contaminate the site during the lease period. Even before SARA defined the term "contractual relationship", at least one court concluded that the third party defense was unavailable to a lessor due to the contractual relationship with the lessee causing the contamination.⁸⁰ The result should be the same after SARA. Under the present definition of the term, a lessor cannot show that he had "no reason to know" of the presence of the contamination *at the time of acquisition* of the property. This language appears to preclude the lessor from raising the third party

78. Larsen and Boman, "Environmental Liability: Lender and Landlord-Tenant Issues," *The Impact of Environmental Regulation on Business Transactions*, Practicing Law Institute, 273, 282 (Sept. 27, 1988).

79. *United States v. South Carolina Recycling and Disposal, Inc.*, 21 *Env't. Rep. Cas.* 1577 (D.S.C. 1984).

80. *United States v. Argent Corp.*, 14 *Env'tl. L. Rep.* (Env'tl. L. Inst.) 20616 (D.N.M. 1984).

defense because of the contractual relationship with his lessee. He must therefore rely on contractual protection devices to avoid the financial burden of environmental response.

Protection Devices

Lenders and Purchasers

The third party defense, or "innocent landowner defense," provides lenders and purchasers with a rare commodity: a valid defense to a CERCLA response action. But the defense is not without a price. The lender who wishes to avail himself of the defense must significantly increase the level of inquiry into the borrower's activities and the property itself prior to the loan commitment. This will increase the transactional costs which will, to some extent, be passed on to the borrower. But to the extent that the market prevents passing those costs on to the borrower, the lender must make a business decision as to how extensive, and consequently how costly, his due diligence inquiry will be. For this reason, the following discussion attempts to present the due diligence inquiry in a step by step fashion. When the lender is satisfied that the completed steps suggest an acceptable level of environment risk, he should be able to end the investigation at a minimal cost.

Before discussing the specific techniques, it is helpful to conceptualize what environmental due diligence is and what it is designed to accomplish. Under the definition of "contractual relationship," a lender or other defendant will be considered to have "reason to know" of the contamination of the site at the time of acquisition unless he can show that "all appropriate inquiry" was conducted prior to the acquisition. "Due diligence" is merely a shorthand way of referring to the "appropriate inquiry" discussed in the statute. The appropriateness of the inquiry is modified and limited by statutory language, such as "specialized knowledge," "appropriate inspection," and "good commercial or customary practices."⁸¹ The level of diligence required to show that the defendant had "no reason to know" of the presence of wastes on the site will differ according to these factors.⁸²

A number of variables can affect the level of diligence required. The first factor should be the nature of the transaction. If the property involved is residential property, a lesser inquiry is required than if the

81. See *supra* note 74 and accompanying text.

82. The legislative history confirms the limiting effect intended by this language. It suggests that the term "specialized knowledge" and other terms means that those in commercial transactions are to be held to higher standards than those in residential transactions. See Congressional Record Statement supporting SARA, 51 Cong. Record 9083.

property was industrial or commercial property. The reason for this is that the statute requires that previous uses be investigated⁸³ and it is reasonable to assume that there will be less risk associated with the use of residential property than with commercial or industrial property. A second and more important variable affecting the level of diligence required is the type of defendant. The statute specifies that the "specialized knowledge" of the defendant must be considered by the court.⁸⁴ A lender will likely have specialized knowledge by virtue of its experience in commercial matters. Likewise, a homeowner will be held to a lesser standard than a purchaser of commercial property.⁸⁵

Although not specifically enumerated in the statute, the size of the transaction should also be a relevant factor. The parties will be more willing to incur increased transactional costs in a large transaction than in a smaller transaction. Moreover, the larger the property, the greater the potential for environmental contamination and extensive liability. Therefore, it is "good commercial or customary practice" to conduct a more thorough review in larger transactions.

The final factor should be the ease with which the contamination could have been discovered. The statute specifies that a court should consider the "obviousness" of the presence of contamination, the ability to detect the contamination by appropriate inspection, and how "commonly known or reasonably ascertainable" information about the property was to the defendant.⁸⁶ If barrels of wastes are visible or noxious odors emanate from the property, even an unsophisticated purchaser should be held to have had knowledge of the contamination. Furthermore, if contamination of this or adjacent property has been widely publicized, this should constitute "commonly known" information about the property, thus destroying the defense.

Because most transactions today involve loans, the due diligence defense has been developed primarily by lenders. For this reason, the following discussion will focus on the loan process, keeping in mind that many of the due diligence techniques apply equally to purchasers.

The wary lender might be tempted to construct a rigid, comprehensive due diligence procedure for every type of transaction, or for every transaction involving commercial or industrial property, or for every transaction above a certain size. This is unwise for two reasons. First, the appropriate level of diligence is modified by the term "good commercial or customary practices." If lenders, in an over-abundance of caution, routinely establish detailed and expensive procedures, they

83. 42 U.S.C.A. § 9601(35)(B) (West Supp. 1988).

84. *Id.*

85. 3 *Toxics L. Rep.* 832 (1988).

86. 42 U.S.C.A. § 9601(35)(B) (West Supp. 1988).

run the risk that this will establish what is a good commercial practice.⁸⁷ Banks who do less may lose their defense, even if such techniques were unnecessary in a particular transaction. Second, these lenders will unnecessarily increase their transaction costs and potentially drive themselves out of the loan market.

Instead, lenders should develop a system for evaluating each transaction. To do this, lenders must understand that their goal is due diligence at the time of acquisition, not at the time of the loan commitment.⁸⁸ The reasons for doing the initial inquiry at the time of the loan application is, of course, to avoid taking a security interest in property that cannot be seized in the future without environmental liability. When the lender decides to foreclose, these techniques must be repeated to ensure that the property has not since been contaminated by the borrower.

There are certain minimal techniques, however, which should be included in every transaction. At some point every lender will likely sell its mortgages in the secondary mortgage market. As mentioned, the lenders in the secondary market have already begun to develop environmental risk policies that require various due diligence techniques to be conducted as a condition to the purchase commitment.⁸⁹ These agencies are primarily concerned with residential property, which generally involves little environmental risk. Therefore, because the primary lender cannot function in commerce without access to the secondary market, these policies should be considered to define the minimum of what is good commercial practice by the primary lender.

Single-family property, presenting the least amount of environmental risk, logically requires only a minimal level of diligence. However, it is not completely free from environmental concerns. For example, its value as collateral may be impaired by on site or neighboring contamination. The key element of due diligence in this context is how "commonly known" the potential risk is in the community. Recognizing this, Fannie Mae places the primary burden on real estate appraisers to search the public records for relevant information and to consider these factors in determining the fair market value of the property.⁹⁰ The lender should be able to rely on the appraiser's onsite inspection and record search as constituting a proper due diligence inquiry in single family transactions. If the appraiser fails to properly investigate the property, the

87. Mott and Slaughter, *Minimizing Lender Environmental Liability: The Most Common Mistakes*, 3 *Toxics L. Rep.* 861 (1988).

88. 42 U.S.C.A. § 9601(35)(A) (West Supp. 1988); *Id.* at 863; see also the summary of EPA policy in Miller and Bennett, *supra* note 66, at 436.

89. Miller and Bennett, *Environmental Risk: Are Your Loans Marketable?*, 3 *Toxics L. Rep.* 618 (1988).

90. *Id.* at 620.

lender should lose his defense because information about the contamination was "commonly known" from the public records or by a simple on-site inspection.

Beyond single-family transactions, Fannie Mae has established more detailed guidelines for multi-family residential properties.⁹¹ To prevent the necessity of conducting a full scale environmental audit in every situation, Fannie Mae breaks the diligence process into two phases. This technique is becoming standard in the lending industry and is being applied as a general structure for the due diligence inquiry in every type of transaction, including commercial or industrial properties.⁹² The following discussion provides the general framework for conducting a due diligence inquiry in various types of transactions and can be used by either purchasers or lenders.

PHASE I

The first phase of the due diligence inquiry involves five basic procedures: the loan questionnaire, the chain of title search, the governmental records search, interviews of various parties, and the site inspection. With the possible exception of single family residential transactions where the lender is allowed to rely on the appraiser's investigation, the careful lender should be able to show that it conducted each of these procedures properly. Otherwise, it might not be able to show that its decision to forego the phase II environmental audit was prudent under the circumstances.

The first step a lender should take is to develop an environmental questionnaire. The questionnaire should address whether the site is vacant or developed, the nature of the borrower's business, prior activities at the site, pending environmental enforcement actions or private lawsuits, and other questions considering the wide range of environmental liabilities that affect different types of businesses. From this information, a loan officer trained in environmental hazards will assess the potential risks and conduct further investigations as required. This will allow the lender to decide the extent of the initial investigation and if the risks look particularly dangerous, whether to proceed at all.

Assuming the lender has decided to proceed with the property investigation process, the next step is the title search. CERCLA requires that the defendant conduct an "appropriate inquiry into the previous ownership" of the property.⁹³ Merely asking about prior ownership in the loan questionnaire would certainly not be appropriate by anyone's

91. *Id.* at 619.

92. *Id.*

93. 42 U.S.C.A. § 9601(35)(B) (West Supp. 1988).

commercial standards. Thus the lender is required to conduct the title search.⁹⁴

Of course, the title search does not tell the lender anything about the condition of the property. It does, however, indicate possession of the property by known polluters, such as chemical companies. It also provides a starting point for the interview process.

The statute further requires the defendant to conduct an appropriate inquiry into previous uses of the property.⁹⁵ A number of due diligence techniques are designed to achieve this requirement. Perhaps the most important is the governmental records search. Governmental agencies at both the local and national level accumulate information about contaminated properties, permit applications, health records, environmental compliance data, and other relevant information. Since this information is available to the general public from federal agencies under the Freedom of Information Act (F.O.I.A.),⁹⁶ and from state agencies under state law,⁹⁷ the courts will probably require a governmental records search under the "commonly known or reasonably ascertainable information" language of CERCLA.⁹⁸

At the federal level, the primary source of information should be the Environmental Protection Agency. Site-specific data should be available through the F.O.I.A., unless a valid trade secret claim can be asserted. This information should include: sites listed or targeted for listing on the National Priorities List⁹⁹ or RCRA underground storage tank registry;¹⁰⁰ facilities violating air, water, and hazardous waste laws; permit applications and permits issued to particular facilities; enforcement actions; computer lists of settlement actions; and other information required to be maintained by the EPA.

In addition to using the EPA as a source of information, a lender or purchaser could obtain information from the filings required to be made to the Securities Exchange Commission, such as the 10-K disclosure documents. Companies subject to registration requirements under the

94. Miller and Bennett, *Due Diligence Techniques For the Innocent Purchaser/Lender*, 3 *Toxics L. Rep.* 434, 437 (1988).

95. 42 U.S.C.A. § 9601(35)(B) (West Supp. 1988).

96. 5 U.S.C. § 552 (1983).

97. For example, in Louisiana, similar rules can be found in La. R.S. 44:1-41 (Supp. 1988).

98. Miller and Bennett, *Governmental Records: An Essential Element of Environmental Due Diligence*, 3 *Toxics L. Rep.* 920, 921 (1988).

99. CERCLA requires that sites targeted for Superfund cleanups be listed on the National Priorities list, 42 U.S.C. § 9605 (1983).

100. RCRA requires owners of underground storage tanks storing hazardous substances to register such tanks, 42 U.S.C.A. § 6991(a) (West Supp. 1988). This program is often administered at the state level, and many tanks remain unregistered.

Securities Act of 1933¹⁰¹ or the Securities Exchange Act of 1934¹⁰² must disclose "material" information to the SEC, its shareholders, and its prospective shareholders. The extent to which environmental litigation is "material" is indicated by the SEC's Regulation S-K, which requires disclosure of environmental litigation when there is serious personal injury, property damage exceeding \$50,000, a life-threatening situation, or a release of radioactive materials or "etiologic agents"¹⁰³ (which includes a "viable microorganism, or its toxin, which causes or may cause human disease").¹⁰⁴

If the property was once used or is proposed to be used by a shipper or carrier, the Department of Transportation (DOT) should also be a source of environmental information. DOT requires shippers and carriers to notify federal authorities of "incidents" involving hazardous materials in transportation.¹⁰⁵ Compliance data can also be obtained through DOT.¹⁰⁶

At the state level, records can usually be found as to the location of underground storage tanks, the locations of landfills and other waste disposal facilities, areas of radon contamination, asbestos records, discharge permits, Community Right to Know disclosures, and other helpful information.¹⁰⁷ There may also be a state agency which maintains "priority lists" for state funded cleanups, much like that kept by EPA. Local health agencies and sanitation departments could also assist in the search for information.

In Louisiana, La. R.S. 30:2194 requires underground storage tanks of 1100 gallons or more to be registered with the Department of Environmental Quality. Additionally, La. R.S. 30:2204 requires any owner, operator, or responsible person of any site to notify the Department of Environmental Quality's Office of Solid and Hazardous Waste of any release or discharge of hazardous wastes. Yet, the Department of Environmental Quality has no integrated filing system among the various offices. Nor has the Department developed a system for handling the increasing number of requests for information by persons attempting to qualify for the third party defense. It is recommended that a request for information relating to a specific company or individual be sent to the Department under the Louisiana Public Records Act.¹⁰⁸ Apparently,

101. 15 U.S.C. §§ 77a et seq. (1981).

102. 15 U.S.C. §§ 78 et seq. (1981).

103. 17 C.F.R. § 231.10 et seq. (1988).

104. 49 C.F.R. §§ 171.8 and 173.386(a)(1) (1988); 42 C.F.R. § 721 (1988).

105. 49 U.S.C. §§ 1802-04, 1808 (1976); 49 C.F.R. §§ 171.3, 171.8, 171.15-16 (1988); 49 Fed. Reg. 10490-10507 (1988).

106. Regulations pertaining to the public availability of DOT records can be found in 49 C.F.R. 7 (1988).

107. Miller and Bennett, *Government Records: An Essential Element of Environmental Due Diligence*, 3 *Toxics L. Rep.* 920, 922 (1988).

108. La. R.S. 44:1-41 (Supp. 1988).

the records are kept by name rather than property description, and the request will be circulated among the various offices to retrieve the information.¹⁰⁹

In summary, lenders and purchasers should become familiar with the type of information available within each agency and how that information may affect the property. By doing so, the loan officer will know which agency to contact for that specific information when a given problem arises. The lender, by being unaware of the availability of such information, runs the risk of having constructive knowledge of the information in the public records. Furthermore, as awareness of the environmental problems associated with real estate grows, the standards for inquiry will increase.¹¹⁰ It is likely, then, that review of government records will become an essential element in every real estate transaction.

Once these record searches are completed, the lender should conduct interviews with various parties connected with the property. This step is designed to fulfill the "commonly known or reasonably ascertainable information" requirement.¹¹¹ Ideally, the lender or purchaser will have a list of names of former owners from its title search. A questionnaire should be sent to each of these former owners to ascertain the previous uses of the property. The same questionnaire should also be sent to the transferor of the property and neighbors. Additionally, these parties should be asked whether they ever leased the property to a third party, because this information is usually not discovered in the chain of title search. Next, the questionnaire should be sent to the former lessees. Specifically, the lender or purchaser should inquire about environmental compliance and past enforcement actions.

It is likely that many of the parties questioned will be reluctant to release information; they may, for example, fear liability for misleading statements in whatever information they disclose. It is important, however, that at least some attempt be made to get this information. If the questionnaire goes unanswered, perhaps a follow up phone call would be in order. All attempts to obtain this information should be documented. If there is still no response, the inference should be that the information was not reasonably ascertainable, and the lender or purchaser should be protected.

The final step of the phase I inquiry is the site inspection. This does not include expensive chemical testing as is done in the environmental audit, but rather requires only a simple visual examination of the site by a knowledgeable party. For example, if the property is a processing or manufacturing plant, the lender should have someone check

109. Telephone conversation with Gordon Green, Legal Affairs Office (April 5, 1989).

110. Miller and Bennett, *supra* note 107, at 922-23.

111. 42 U.S.C.A. § 9601(35)(B) (West Supp. 1988).

for: required pollution control equipment; for stains or evidence of corrosion; for asbestos and PCB's; storage containers; fuel kept on site; pipelines; and record keeping practices. If the site is unimproved land, the terrain should be checked for discoloration, absence of vegetation, filled areas, stormwater ditches or conduits, pits or lagoons, and the presence of any wastes disposed of or stored on the site. Of course, other types of diligence techniques may alert the lender or purchaser to more specific evidence of contamination.

This does not mean that an extensive on site inspection should be conducted in every transaction. However, the statute implies that some type of inspection should be made. Section 101(35)(B) provides that the "obviousness" of the contamination and the ability to detect the contamination by an appropriate inspection must be considered by the court.¹¹² Because the lender will likely be perceived as a "deep pocket" defendant, the court may be tempted to conclude that the statute requires some type of visual inspection in *every* transaction, even if the other diligence techniques do not raise suspicions about the property. This will especially be true if the presence of the contamination could have been readily discovered by a simple inspection of the site. Moreover, the site inspection often discloses information not available elsewhere. For example, an illegal dumper could have deposited barrels of wastes on the site, and this fact could not be discovered from interviews or from the public records. In large expensive transactions, or in those where a doubt has been raised, the on-site inspection could be conducted by an expert in the phase II environmental audit. In general, though, someone should check the site for obvious contamination in every transaction.

It may be economically infeasible, however, to conduct an on-site inspection in every transaction. Consultants that provide such services typically charge several thousand dollars, an added cost that smaller residential and commercial transactions simply cannot afford. Thus, it has been suggested that phase I be separated into phase I(a), which includes the questionnaire and record searches, and phase I(b), which includes the on-site inspection.¹¹³ Under this technique, the phase I(b) inspection could be bypassed in smaller transactions where no suspicions are raised by the phase I(a) investigation.

The above argument makes sense as far as commercial feasibility is concerned, but it presents other problems in fulfilling the statutory requirements. The "obviousness" of the contamination and the ability to detect the contamination by an appropriate inspection suggests that

112. Id.

113. Bennett, *Environmental Due Diligence: An Evolving National Standard*, 3 *Toxic L. Rep.* 1262, 1264 (1989).

the due diligence inquiry could be inadequate where no inspection was conducted. The "appropriate inspection" requirement could be interpreted as necessitating no inspection at all in circumstances where it is commercially infeasible. However, such a reading ignores the statutory requirement that the court consider the obviousness of the wastes on the site.¹¹⁴ The structure can be useful, however, as long as some visual inspection was conducted in phase I(a), perhaps by an appraiser trained to recognize evidence of contamination. A more thorough site inspection by an environmental consultant could be conducted in phase I(b) or in phase II, if necessary. Furthermore, the argument that the on site inspection is commercially infeasible in smaller transactions will become less convincing as consultant firms develop and offer lower costs for a higher volume of work.

The argument that some sort of site inspection must be conducted in every transaction is reinforced by legislation currently being drafted in Congress. The bill is being introduced in response to the inability to define "all appropriate inquiry." The proposed definition would require that the investigation include a title search, public records search, and a visual site inspection in every transaction.¹¹⁵

Phase I is completed when all of the above mentioned procedures have been done properly. Next, the lender or purchaser must evaluate the information he has received to decide whether further investigation is warranted. In reviewing documents, the lender should be especially suspicious of evidence of previous uses of the property to produce chemicals, pesticides, fertilizers, or types of manufacturing known to present environmental problems. The documents should also be reviewed to determine whether record keeping requirements have been complied with. Otherwise, there will be doubt as to the presence of wastes from undocumented activities. Prior enforcement actions should be reviewed for the severity of the releases. Finally, this information should be considered in conjunction with any problems that were discovered by the on-site inspection. In addition, the statute requires that the defendant consider the relationship of the purchase price to the value of the property if uncontaminated.¹¹⁶ It is possible that this could be the sole suspicious factor discovered during phase I, but could still be considered enough to necessitate a phase II environmental audit.

114. But see *United States v. Pacific Hide and Fur Depot Inc.*, 3 Toxics L. Rep. 1619 (D.C. Idaho 1989), where the district court held that "no inquiry" was "appropriate" in an interfamilial gratuitous transaction where the children receiving the gift were "barely out of their teenage years." The court went on to state that "[t]his is precisely the situation designed to be covered by the innocent landowner defense."

115. 19 *Envtl. Rep.* 2569 (1989).

116. 42 U.S.C.A. § 101(35)(B) (West Supp. 1988); *Miller and Bennett, Due Diligence Techniques For the Innocent Purchaser/Lender*, 3 Toxics L. Rep. 434, 438 (1988).

If any of the above investigations would raise suspicions in a reasonable person, considering the statutory limitations of this term, the lender or purchaser should either reject the transaction or loan, or proceed with the phase II environmental audit. If the transaction is a very large one, the parties may decide to incur the expenses of further investigation purely in the interest of caution.

PHASE II

The term "environmental audit" is loosely defined. Often it is used to describe the entire investigatory process, while other times it is used to describe any type of physical inspection of the property. For purposes of this comment, the term will be used to refer only to soil or groundwater sampling, or certain types of surface inspection or testing. The reason for this restrictive definition is the conclusion that some type of minimal visual inspection will be required in every transaction in order to fulfill the statutory requirement that the defendant conduct an "appropriate inquiry" into the "obviousness" of the presence of the contamination, and the ability to detect the contamination by appropriate inspection.¹¹⁷ While the extent of the on-site inspection will vary according to each individual transaction, the fact that some type of investigation is necessary in order to claim the defense warrants the more restrictive definition. Therefore, the simple on-site inspection is considered part of the phase I inquiry, which should be conducted routinely, while the more extensive on-site inspection is part of the environmental audit conducted in Phase II.

Generally, an environmental audit is conducted by environmental experts. The sampling process must be undertaken with accepted procedures to ensure the reliability of the test, and lenders and purchasers are usually not able to properly conduct the audit themselves.¹¹⁸ The objectives are to identify the amount and types of contaminants in the soil or groundwater and to predict the rate and direction of migration of the contaminants. If the audit refutes the suspicions raised by the phase I inquiry, the lender or purchaser may proceed with the transaction without losing his defense. However, if the audit confirms suspicions of contamination, the lender or purchaser is considered to have actual knowledge of the contamination and may not claim the third party defense. In addition, the parties should consider whether the contamination must be reported to the appropriate government agency. Moreover, if title is finally taken, the purchaser must take reasonable steps

117. 42 U.S.C.A. § 101(35)(B) (West Supp. 1988).

118. Miller and Bennett, *supra* note 116, at 438.

to prevent harm to the public, which could include a cleanup of the property.¹¹⁹

Even if a lender fulfills all of the above requirements, it still may lose the third party defense. Section 101(35)(B) requires that the defendant take the appropriate steps "in an effort to minimize liability."¹²⁰ This language was interpreted by a former member of the Environmental Protection Agency as requiring lenders to:

- 1) Avoid participation in the management of the borrower's business . . .
- 2) Where practicable, prohibit the handling of hazardous waste by the borrower.
- 3) Where waste must be handled, require compliance practices and policies.
- 4) If possible, require the borrower to obtain environmental impairment liability insurance.
- 5) If the borrower's property is contaminated, consider refraining from foreclosing and taking title.¹²¹

The implication is that failure to take the above steps could jeopardize the defense.

While it is a good practice for a lender to attempt to follow each of these suggestions, the absence of a contractual prohibition against the borrower's handling or mishandling of certain wastes should not destroy the defense. These provisions are often the subject of intense negotiation and should not by themselves complete or destroy the third party defense. Furthermore, there is no statutory authority for requiring potential defendants to demand such provisions. The language "in an effort to minimize liability" relates only to the appropriateness of the investigation, not to any other defense or contractual protection device available to defendants.

Even if the above suggestions are incorrect, lenders and purchasers should include representations, warranties, covenants and indemnity provisions in the transaction documents. The value of these provisions as protection for the lender depend on the solvency of the borrower, and may appear of little worth. However, they do help illustrate that the lender made a diligent effort to discover the presence of the wastes.¹²² This may help in avoiding liability under CERCLA by helping to show

119. 42 U.S.C. § 9607(b)(3) (1983), provides that the defendant must exercise due care with respect to the hazardous substance discovered.

120. 42 U.S.C.A. § 9601(35)(B) (West Supp. 1988).

121. Miller and Bennett, *supra* note 116, at 435 (citing Reich and Leifer, *The Effect of CERCLA on Property Transfers*).

122. King, *supra* note 59, at 286.

that the lender or purchaser had no reason to know of the presence of the contaminants.

The warranties should include a provision that the borrower knows of no hazardous waste on the property before or during his ownership. Another section should state that the borrower is now and will remain in compliance with all environmental laws, that no conditions exist or are likely to exist which would subject the borrower to an enforcement action or other environmental liability, and that the borrower is not currently involved in such actions. The borrower should also warrant that he has all licenses and permits required by law. Finally, the borrower should agree to notify the lender immediately of a breach of any of the above conditions and representations.¹²³

Indemnity provisions in a contract may not be raised as a defense to a CERCLA response action.¹²⁴ The same is true under Louisiana law.¹²⁵ But the validity of such agreements as between the parties are specifically preserved in both the state and federal statutes. However, as with warranties and covenants, they are only valuable as long as the indemnitor remains solvent. In the lender/borrower relationship, there is a significant chance that the borrower will be insolvent by the time the agreement is invoked. Such a provision may be more valuable to a purchaser receiving title from a solvent seller, since there is greater likelihood that the seller will be solvent after the wastes are discovered. Nevertheless, indemnity agreements can be as broad or as narrow as the parties wish, and should be carefully negotiated.

Another protection device available to lenders is to avoid taking a security interest at all, instead relying on a personal guaranty from a solvent principal. Since the lender will never have to foreclose on the property, it does not have to worry about claiming the third party defense. Instead, the lender merely becomes a member of the group of other creditors of the principal.

Finally a lender should be careful to remove from its loan documents old provisions which could be construed as participating in the day to day management of the borrower. Examples of these provisions include control over selection of the borrower's management or participation in the borrower's business operations. On the other hand, purely financial controls such as net worth requirements should remain.¹²⁶ This will allow the lender to protect its security interest without incurring the type of liability imposed in the *Mirabile* case.

123. *Id.* at 286-87.

124. 42 U.S.C. § 9607(e)(1) (1983).

125. La. R.S. § 30:2278 (1989).

126. King, *supra* note 59, at 288.

Lessors and Lessees

As was explained in section II, a lessor may not assert the third party defense for contamination caused by his lessee.¹²⁷ Because of this, the lessor should be particularly concerned about the allocation of rights and responsibilities between the parties. There are a number of devices available to the lessor to insure that the lessee will pay for any costs associated with a clean up.

If the lessee's business involves the use of some hazardous substances, the lessor should require the lessee to comply with all applicable environmental laws. Any hazardous substance not normally used in the lessee's business should be barred from the premises. The lease should specifically provide that the lessee will identify the substances expected to be used or generated on the property, and that the lessee will notify the lessor of any release of those substances.¹²⁸ Such a release should be grounds for default, triggering the lessor's right to terminate the lease and collect response costs. This will at least enable the lessor to prevent any further contamination of his property.

The lessor could also try to insert an indemnity clause in the lease. The lessee will likely resist an over broad provision, so the scope of the indemnity will have to be negotiated. Further, if the lessee will agree, the lessor should negotiate a pass-through clause in which cleanup costs would be passed on to the lessee as operating costs. The lessee will likely limit this provision to any contamination caused by him, and not contamination caused by the lessor or third parties. The same should be true of maintenance covenants.¹²⁹ The lessor should also reserve the right to refuse any assignment of the lease to a sublessee who might increase the chances that the lessor will incur response costs.

Since the lessee should not be liable for prior contamination of the site, his primary concern will be proving that the contamination occurred prior to his lease. The lease should require the lessor to disclose past uses of the property and any hazardous substances that may be located there. Failure to do this would be grounds for termination or rescission of the lease. The lessee should specifically exclude from his maintenance responsibilities any liability for substances not released by him. Furthermore, the lessee should demand to be indemnified for any liability it incurs for release by the lessor or third parties. The lessor should be required to notify the lessee of the presence or release of hazardous substances that he discovers. Failure to comply with any of the above

127. See *supra* note 79 and accompanying text.

128. Larson and Boman, "Environmental Liability: Lender and Landlord-Tenant Issues," *The Impact of Environmental Regulation on Business Transactions*, Practicing Law Institute, 273 (Sept. 27, 1988).

129. *Id.*

could be specified as grounds for termination of the lease, but this will likely be the subject of negotiation. Finally, the lessee could request that an environmental audit be performed at termination of the lease so that he can prove that he was not responsible for any wastes deposited there later.¹³⁰

CONCLUSION

Lenders, purchasers, lessees and lessors all face serious environmental liability in transactions involving immovable property. Lenders and purchasers must be concerned with taking title to property and becoming liable as "owners or operators" under CERCLA. In addition, lenders must be concerned with becoming overly involved in the operation of the borrower's business. Lessees share many of the same concerns as purchasers, since they are acquiring an interest in property similar to purchasers. Lessors, on the other hand, already own the property and are more concerned with regulating the activities of lessees.

Lenders and purchasers must conduct a due diligence inquiry before they acquire an interest in real property in order to later assert the third party defense. This inquiry should be conducted in phases in the hope of avoiding the expense of a full environmental audit. In all but single family residential transactions, the inquiry should include a title search for previous owners, a governmental records search for previous uses of the property, and interviews of various parties discovered in the above two searches and in the initial questionnaire completed by the borrower, seller, or lessor. Finally, there should be at least some visual inspection to discover obvious or easily ascertainable information about the property. If any of the above raise the suspicions of a "reasonable" person, as that term is limited by the statute, then an environmental audit should be conducted. Only then may a defendant assert the third party defense.

Other protection devices are available by way of contract. The lender or purchaser could demand warranties about the condition of the property and the seller or borrower's knowledge about past disposal practices. Compliance with environmental laws should be required, and an indemnity clause could be used to reimburse the lender or purchaser for any costs incurred in responding to contamination caused by others. The personal guaranty of the borrower's principals are useful both for collecting the debt and as an assurance that the principals are negotiating honestly and in good faith.

The lessor is in a different position, because he already owns the property or, as a sublessor, is in the position of owner at the time of the contamination. Since he cannot show that he "acquired" the property

130. *Id.* at 287-288.

without actual or constructive knowledge about the presence of the wastes, he cannot claim the third party defense. He must therefore rely on contractual devices designed to prevent the contamination or shift the responsibility to the lessee. Similarly, the lessee is not concerned with the third party defense for contamination caused prior to his possession of the property. Instead, he is concerned with the contractual relationship with his lessor during his possession of the property. Disclosure, maintenance, notice, and indemnity provisions should all be considered when negotiating a lease with a potential environmental risk.

The statutory scheme is workable only if it is interpreted in light of the economic feasibility of fulfilling the statutory requirements on a regular basis. The statute attempts to deal with the problem of increased transactional costs by incorporating the language "consistent with good commercial or customary practices," but then compounds the problem by specifying a variety of factors that the court must consider in each transaction. A party wishing to claim the defense must therefore develop a specific technique to fulfill each factor, which increases the transactional costs. However, as uniform due diligence techniques established in the secondary market and elsewhere develop and become accepted as "good commercial practices," there will be no need to overspend due to the uncertainty of qualifying for the defense. Moreover, as companies develop the capacity to handle due diligence inquiries at a higher volume, the costs of investigating a particular property will be reduced. Thus, the statute is workable in its present form, provided the courts follow the lead of the secondary market institutions as they attempt to develop an economically feasible approach to the third party defense.

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