Lenders and environmental policies

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One of the major issues influencing economic development in the nineties is the possible impact of environmental laws and regulations. Many analysts expect the effect to be significant as companies seek to comply with environmental requirements.

Among those increasingly affected by environmental policies are lenders who generally provide the funds to borrowers for business operations and expansion. Lenders have found themselves at risk for environmental compliance both indirectly, when a borrower is faced with the added costs of complying with environmental laws, and directly, when a borrower defaults on a loan.

This article examines the liability of lenders and the nature of the risk exposure for financial institutions as a result of environmental laws and regulations. It reviews the recent court record relating to financial institution lending associated with contaminated properties. It discusses proposed measures to reduce the uncertainty for lenders under current environmental policies. And, given the long history of industrial activity within Seventh District states—Illinois, Indiana, Iowa, Michigan, and Wisconsin—it considers whether this area may be more affected by environmental policies than elsewhere in the United States.

Environmental legislation

On January 1, 1970, President Nixon signed into law the National Environmental Policy Act of 1969 (NEPA) which established environmental protection and preservation of our natural resources as a national policy. The act provided for an Environmental Protection Agency (EPA), the President's Council on Environmental Quality, and an environmental impact review program. With the founding of the EPA in December 1970, the environmental movement entered a new phase.

Other major environmental legislation followed. Most of this legislation was directed primarily toward monitoring and regulating the ongoing activities of individuals and corporations that might contribute to a deterioration in our environment. Among the legislation either enacted or amended was the Clean Air Act, the Solid Waste Disposal Act, amended by the Resource Conservation and Recovery Act (RCRA) of 1976, the Toxic Substances Control Act (TSCA), and the Safe Drinking Water Act.

In 1978, the conditions in the Love Canal community, which had been built over an abandoned hazardous waste dump in upstate New York, prompted Congress to investigate the problems associated with toxic waste sites. The resulting legislation, the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), commonly known as the Superfund act, was enacted, according to its preamble, "to provide for liability, compensation, cleanup, and emergency response for hazardous substances released into the environment and the cleanup of inactive

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hazardous waste disposal sites." The law was subsequently amended by the Superfund Amendments and Reauthorization Act of 1986 (SARA)[1].

The passage of CERCLA ended the disinterested party status of financial institutions. Previously, for the most part, financial institutions were bystanders and not directly affected by environmental legislation. Many were of the opinion that the environmental law developments were a concern only for those enterprises that produced some form of environmental externalities, such as smoke, solid waste, and water discharges.

The intent of CERCLA was to assign the cost of cleanup of contaminated sites to the responsible parties. In addition to the parties responsible for placing the contamination in the ground, the act assigned responsibility to successors in the chain of title, for example, the present property owner. The third parties responsible for the cleanup costs are those "associated" with the title to the contaminated property, for example, a mortgagee. It is in this third grouping that financial institutions have found themselves at risk. This risk exposure has led to and may continue to lead to significant financial losses associated with lending to enterprises responsible for contaminated properties.

CERCLA identifies four broad classes of responsible parties that are liable for the costs of cleaning up hazardous substances when the federal government, state government, or a private party brings suit. The first two classes include any person owning or operating a vessel or an onshore or offshore facility, that is, owners or operators. If the title or control to a facility is conveyed to a unit of state or local government due to bankruptcy, foreclosure, or tax delinquency, the person who owned, operated, or otherwise controlled activities at such a facility immediately before the transfer remains the responsible owner or operator. The third class includes persons who arranged for disposal, treatment, or transportation of hazardous substances. The fourth class includes those who transported any hazardous substances to selected sites.

Persons included in the four classes may be exempt from liability if they can establish that they acquired the contaminated property after the disposal or placement of the hazardous substance at the facility and if they are able to claim the "innocent landowner's" defense. To do so, they must establish that they exercised what is called "environmental due diligence," that is, at the time they acquired the facility, they did not know and had no reason to know that any hazardous substance was disposed of at the facility. To establish that they had no reason to know, the law provides that they must have undertaken, at the time of the acquisition, all appropriate inquiry into the previous ownership and use of the property consistent with good commercial or customary practice.

The definition of "owners or operators" of facilities as potentially liable parties under CERCLA includes an exemption for persons who hold a "security interest" in a facility. According to the law, the owner or operator definition does not include "a person, who, without participating in the management of a vessel or facility, holds indicia [a form] of ownership primarily to protect his security interest in the vessel or facility."

Interpretation of this "security interest" exemption under CERCLA has generated uncertainty within the financial and lending communities, particularly with regard to the extent to which a secured creditor may undertake activities to oversee the affairs of a borrower or debtor, for the purposes of protecting the security interest, without incurring CERCLA liability. Specifically, there is concern over whether certain actions commonly taken by the holder of a security interest—such as monitoring facility operations, requiring compliance activities, refinancing or undertaking loan workouts, providing financial advice, and similar actions that may affect the financial, management, and operational aspects of a business—are properly considered to be evidence that the security holder is "participating in the management of a facility." There is also concern regarding the effect of foreclosure on the security interest exemption of the lender.

Recent major court cases

Court cases have gradually been addressing the issues of lender responsibilities and liabilities. Two types of cases are of particular interest to lenders; those involving the "innocent landowner's" defense and those involving the security interest exemption. Cases involving the innocent landowner's defense are of interest to lenders because of the impact of compliance with environmental law on the borrowers' ability to repay the loan, the consequent default risk, and the risk assumed by the lender if foreclosure is necessary. Cases involving the security interest exemption are of interest because of the uncertainty surrounding the type of activities which might be engaged in by the lender to monitor the loan and the extent of the risk exposure.

In an early 1985 bankruptcy case, *In re T. P. Long Chemical, Inc.*,[2] the EPA applied to be reimbursed by the bankruptcy estate for costs incurred in removing drums of hazardous substances discovered on the property of the debtor, a rubber recycling company. Some of the funds in the estate represented the proceeds from an auction by the trustee of personal property in which a bank held a security interest. The court relied on the security interest exemption to find that the bank as a secured creditor was not liable for costs incurred by the EPA under CERCLA. The court stated that if collateral becomes worthless or poses a risk to the public, the secured creditor is under no obligation to assume possession of the collateral or to insure against the risk. Furthermore, if the bank had repossessed its collateral, it would not be an "owner or operator" as defined under CERCLA because its only "indicia of ownership" was primarily to protect its security interest and it had not participated in the management of the facility.

Subsequently in 1985 a seminal case addressed the protection provided to lenders by the security interest exemption from the liability imposed on owners and operators. In *United States v. Mirabile*,[3] a bank, one of the secured creditors, foreclosed on its mortgage and successfully bid at a sheriff's sale for the property of a defunct business that had created a hazardous waste. Four months later the bank assigned its bid to the Mirabiles. When the EPA sued the Mirabiles to recover its cleanup costs, the Mirabiles joined the bank as third-party defendants. The court held that a lender may be liable as an "owner or operator" of contaminated property if it participates in the day-to-day "operational, production, or waste disposal activities" of its borrower's business on the property. However, facility monitoring, involvement in financial decisions, restrictions on financial decisions contained in loan documents, and general financial advice were permissible. In addition, the court stated that the mere financial ability to control waste disposal practices was not sufficient for the imposition of liability. The court found that the bank was not liable because it had not participated in the management of the business, and its actions after foreclosure were undertaken merely to protect its security interest in the property. Foreclosure and repurchase were considered to be a natural consequence of protecting a security interest.

The following year, in the case of *United States v. Maryland Bank & Trust Company*,[4] a district court adopted a narrower interpretation of a lender's liability after foreclosure. In the *Maryland Bank* case, the EPA sued the bank under CERCLA for reimbursement of the costs of cleanup of a hazardous waste dump after the bank had foreclosed on the property. Maryland Bank, although clearly the owner, claimed that it held title to the property "primarily to protect its security interest in the property," and was, therefore, not an owner as contemplated by the statute. However, the court found that Maryland Bank had "purchased the property at the foreclosure sale not to protect its security interest, but to protect its investment." Only during the life of the mortgage did the Bank "hold indicia of ownership primarily to protect its security interest in the land." Further, the court noted that Maryland Bank had held title for nearly four years after foreclosure and for a full year before the EPA cleanup and that the *Mirabile* decision "pertained to a situation in which the mortgagee-turned-owner promptly assigned the property [after four months]." Consequently, according to the court, current ownership after foreclosure in this case was sufficient to impose liability on the bank, even if the bank was not operating the contaminated facility. As a result, Maryland Bank had to pay more than half a million dollars in cleanup and court costs and was unable to recover its costs or original investment on resale.

Although the court in the *Maryland Bank* case did not address the issue, there is the possibility that a lender, otherwise liable, can take advantage of the "innocent landowner's" defense to liability normally available to a purchaser. For this defense, the purchaser must have "undertaken, at the time of the acquisition, all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice"—the so-called "environmental due diligence." On the assumption that the lender may be an owner after foreclosure, he or she may also need to prove that appropriate inquiry was made when the loan was approved and prior to foreclosure.

In *U.S. v. Nicolet, Inc.*,[5] the court also considered the application of the security exemption exclusion to mortgagees. In *Nicolet*, a parent corporation, T&N plc, owned all of the stock of a subsidiary, Keasbey & Mattison Company, the previous owner of Nicolet's contaminated site, and held a mortgage on Keasbey's property. The court denied a motion by T&N plc to dismiss the government's complaint that T&N plc was directly liable because it held a mortgage on the site and actively participated in the management of the facility. Without reaching a final decision on liability, the court stated that "existing case law suggests that a mortgagee can be held liable under CERCLA only if the mortgagee participated in the managerial and operational aspects of the facility in question." In a consent decree, T&N plc subsequently agreed to implement the remedy called for by the EPA.

A subsequent case in 1989, *Guidice v. BFG Electroplating and Manufacturing Co., Inc.*,[6] also addressed bank liability prior to and after foreclosure on contaminated property on which it held a mortgage. In this case, the court relied on the standards stated in *Mirabile* and *Nicolet* in reviewing the bank's activities and concluded that the key question was "whether the bank had passed the point of protecting its security interest and was participating in the management or control" of its borrower. Finding that there was "no evidence suggesting that the bank controlled operational, production, or waste disposal activities" at the facility prior to foreclosure, the court ruled that the bank fell within the security interest exemption for this period. After the foreclosure and the bank's purchase of the property at the sheriff's sale (which it sold after eight months), the court relied on the *Maryland Bank & Trust* decision and the failure of the 1986 CERCLA amendments to specifically exempt mortgagees-turned-landowners to hold the bank liable "to the same extent as any other bidder at the (foreclosure) sale would have been." The court indicated that it viewed lenders as serving an environmental policing function by paying close attention to environmental compliance to protect their financial stake.

A recent decision in the U.S. Court of Appeals for the Eleventh Circuit, *United States v. Fleet Factors Corp.*,[7] however, has introduced additional uncertainty into the meaning of the security interest exemption and the extent of lender liability under CERCLA. In this case, Fleet Factors, a commercial factoring firm, advanced funds to a cloth printing company on the company's accounts receivable, with its facility and its equipment, inventory, and fixtures as collateral. After the textile firm was adjudged bankrupt, Fleet Factors foreclosed on its security interest in inventory and equipment and arranged for its sale and removal, but did not foreclose on its mortgage on the facility. The EPA subsequently found hazardous waste on the property and sued to recover its costs of cleanup. The district court adopted the interpretation of the security interest exclusion previously accepted by other courts, stating that the exclusion permits secured creditors to "provide financial assistance and general, and even isolated instances of specific, management advice to its debtors without risking CERCLA liability if the secured creditor does not participate in the day-to-day management of the business or facility either before or after the business ceases operation." The court denied Fleet Factors' motion to dismiss the government's complaint, but granted Fleet Factors the right to appeal. On appeal, the Eleventh Circuit disagreed with the district court's interpretation of the CERCLA security interest exemption and remanded the case for further analysis consistent with its interpretation. The Eleventh Circuit stated that a secured creditor may be liable under CERCLA "by participating in the financial management of a facility to a degree indicating a *capacity to influence* (emphasis supplied) the corporation's treatment of hazardous wastes. It 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. Nor is it necessary for the secured creditor to participate in management decisions related to hazardous waste. Rather, a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose." In contrast to previous cases, which permit lenders to exercise general financial controls over a troubled borrower, the appellate court stated that the lender's capacity to influence a debtor facility's treatment of hazardous wastes may be inferred from the extent of its involvement in the financial management of the facility. Thus, according to the court, Fleet Factors could be held liable as the "owner" of the facility because Fleet Factors' mortgage on the property constituted an "indicia of ownership," and its involvement in either the financial management or the operational management of the facility could cause it to lose its security interest exemption.

In support of its interpretation, the Eleventh Circuit reasoned that the lower the threshold of control employed to determine whether the benefit of the exemption had been lost, the greater the incentive would be for lenders to play the role of environmental policeman to keep borrowers in compliance. The court reasoned that its ruling would encourage lenders to investigate the potential borrower's environmental practices and to factor the discovered risks of CERCLA liability into the terms of the loan agreement. The lower threshold would also encourage lenders to monitor borrowers' waste management practices and "insist upon compliance with acceptable treatment standards as a prerequisite to continued and future financial support."

A subsequent decision by the Ninth Circuit Court of Appeals, *In re Bergsoe Metal Corp.*,[8] however, stated that the mere capacity or unexercised right to control facility operations is insufficient to void the security exemption, and stated that "there must be some actual management of the facility before a secured creditor will fall outside the exception." In its discussion of what constitutes management, the court held that "a secured creditor will always have some input at the planning stages of any large-scale project and, by the extension of financing, will perforce encourage those projects it feels will be successful. If this were 'management,' no secured creditor would ever be protected." In addition, the court held that certain rights that a secured creditor reserves to protect its investment, such as the right to inspect the premises and to reenter and take possession upon foreclosure, does not put it in a position of management. According to the court's decision, "what is critical is not what rights the Port (the creditor) had, but what it did. The CERCLA security interest exception uses the active 'participating in management.' Regardless of what rights the Port may have had, it cannot have participated in management if it never exercised them."

The recent *Fleet Factors* and *Bergsoe* decisions have introduced additional uncertainty into the question of the liability of lenders for hazardous wastes produced by the operations of borrowers. Of particular concern are the extent to which lenders may oversee the activities of debtors, particularly troubled borrowers, without being considered to be participating in management, and the effect of foreclosure and subsequent purchase of the collateral by the creditor. The resulting new risks in lending are discussed below.

Traditional risks in lending

Prior to the passage of environmental legislation, particularly CERCLA, during the last two decades, a financial institution's risk associated with lending was generally considered to consist of two elements: default risk and market or interest rate risk. Default risk is related to the probability that the debtor will be unable to perform all of the legal requirements set forth in the loan contract. Most frequently, default is triggered when the borrower fails to meet principal and interest payments in accordance with the terms of the contract. To minimize their exposure to default risk, financial institutions frequently secure loans with collateral. Thus, if the borrower defaults on the loan, the financial institution is able, in theory, to sell the collateral and recover all or a portion of the loan. The maximum possible loss to the financial institution arising from default risk should be no greater than the size of the loan outstanding, plus any legal and administrative costs.

The second type of traditional risk in lending is called market or interest rate risk. For example, as long term interest rates fall, mortgages tend to be refinanced or paid off. The financial institution is then in a position of having to reinvest those funds at the lower market interest rate. Alternatively, as rates rise, the financial institution may be caught holding assets that are yielding a return less than the current market rate.

New risks in lending

Environmental laws and regulations have introduced additional uncertainty and a new dimension to risk for financial institutions in lending. Compliance with environmental legislation in general represents an indirect risk to the lender because of the requirements imposed on the borrower. In reviewing the default risk, the lender must also now consider the borrower's current and potential costs of compliance with environmental laws and regulations. If the compliance imposes an additional financial burden on the borrower, he or she may be less able to pay the interest and principal of a loan. Thus the lender must be assured that the borrower has exercised "due diligence" and is protected by the "innocent landowner's" defense in the acquisition of property which may or may not be used as collateral for the loan. The lender must also be reasonably certain that the borrower is aware of any environmental laws and regulations which might be expected to affect the operation of his or her business.

The new dimension to the risks faced by a lender is that a financial institution may become liable for the costs of cleanup of contaminated property owned by a borrower. The "security interest exemption" was intended to limit the exposure of lenders to such liability, but it requires that lenders not participate in the management of the borrower's business. As discussed in the previous section, recent court decisions have introduced additional uncertainty into what activities are permitted by the lender without losing the security interest exemption. If the security interest exemption is lost and the lender is adjudged to have acted as an owner or operator, the lender may incur environmental cleanup costs which exceed the total amount of the loan.

Much of the uncertainty revolves around whether there should be a low or high threshold for "participation in management" and therefore for lender liability for cleanup. A low threshold means that lenders would be considered to be participating in management even though there was very little oversight of their borrowers' operations. Some advocates of a low threshold believe that lenders would thus be more likely to monitor borrowers' compliance with environmental laws and regulations, rather than risk liability for the costs of cleanup. Lenders would, in effect, serve as environmental auditors. According to the decision in *Fleet Factors*, the ruling was expected to "encourage potential creditors to investigate thoroughly the waste treatment systems and policies of potential debtors. If the treatment systems seem inadequate, the risk of CERCLA liability will be weighed into the terms of the loan agreement. Creditors, therefore, will incur no greater risk than they bargained for and debtors, aware that inadequate hazardous waste treatment will have a significant adverse impact on their loan terms, will have powerful incentives to improve their handling of hazardous wastes.

"Similarly, creditors' awareness that they are potentially liable under CERCLA will encourage them to monitor the hazardous waste treatment systems and policies of their debtors and insist upon compliance with acceptable treatment standards as a prerequisite to continued and future financial support. Once a secured creditor's involvement with a facility becomes sufficiently broad that it can anticipate losing its exemption from CERCLA liability, it will have a strong incentive to address hazardous waste problems at the facility rather than studiously avoiding the investigation and amelioration of the hazard."

Those opposed to a low threshold believe that this would represent additional risks for lenders for which they may not be compensated. Limiting the oversight activities of borrowers' operations to avoid being considered to be "participating in management" would increase the risks to lenders because they would have less information about the operations of borrowers. Lenders are reluctant to make loans where there are additional risks which may be highly uncertain and unquantifiable. In the *Guidice* ruling discussed above, the court stated that "a low liability standard would encourage a lender to terminate its association with a financially troubled debtor and expedite loan payments in an effort to recover the debts."

A high threshold means that a lender would be able to engage in more monitoring of and advising about a borrower's activities without being considered to be "participating in management." In this case, it would be in the interests of the lender to be sure that the borrower is complying with environmental laws and regulations, because failure of the borrower to do so increases his or her liability for cleanup costs and the risk of defaulting on the loan. The decision in the *Guidice* case states, "A goal of CERCLA is safe handling and disposal of hazardous waste. To encourage banks to monitor a debtor's use of security property, a high liability threshold will enhance the dual purposes of protection of the banks' investments and promoting CERCLA's policy goals."

It is important that the appropriate level of threshold for participation in management by lenders be resolved. Although a low threshold may encourage lenders to more carefully assess the risks involved prior to lending with contaminated property as collateral, the inability to carefully monitor the borrower's operations after the loan is made without incurring CERCLA liability will generally restrict the availability of credit for such loans. A high threshold, on the other hand, will enable the lender to more closely monitor a borrower's operations to prevent default and assure compliance with environmental laws and regulations without incurring CERCLA liability.

In either case, lending with possibly contaminated property as collateral involves extra costs for environmental inspections and appraisals. Monitoring the activities of borrowers to ensure compliance with environmental laws and regulations increases the costs of servicing the loan for lenders. Although the terms of the loan can include the recovery of some costs, the extent of the risk assumed by the lender may be difficult to quantify. Consequently, some risk may be uncompensated.

If the borrower defaults on the loan, foreclosure on property serving as collateral presents additional risk and uncertainty. If the lender acquires the property upon foreclosure, he or she may be considered as the owner liable for cleanup of contaminated properties. In addition, the property may not be saleable because it is contaminated.

Proposed clarifications of lender liability

As discussed above, recent court decisions on lender liability under environmental law have increased uncertainty among banks and other lenders and may affect the availability of credit. Currently, both the EPA and Congress are attempting to rectify the situation.

In August 1990, in response to concern regarding the possible effects of lender liability on the availability of credit, the EPA promised a House panel that the agency would issue a rule to clarify the bounds of the "safe harbor" provided by the CERCLA security interest exemption. After a number of reviews and revisions the EPA proposed rule was announced on June 5, 1991.[9] The proposed rule is an interpretation of the existing "security interest exemption" to CERCLA liability of both privately owned financial institutions and governmental loan guarantors or lending entities.

The EPA rule recognizes that security holders that possess an ownership interest in a facility may need to undertake certain activities in the course of protecting their security interest to properly manage their loan portfolios. Such activities may include inspections or monitoring of the borrower's business and collateral, providing financial or other assistance, engaging in loan workout activities, and foreclosing on secured property. In recognition of the need for these activities, the EPA rule describes a range of permissible activities that may be undertaken by a private or governmental lending institution in the course of protecting its security interest in a facility, without being considered to be participating in the facility's management and thereby voiding the exemption. To clarify the *Fleet Factors* decision, it states that participation in management means "actual participation in the management or operational affairs by the holder of the security interest, and does not include the mere capacity, or ability to influence, or the unexercised right to control facility operations."

The EPA regulations also provide a safe harbor allowing the lender either to foreclose on the property or to take a deed in lieu of foreclosure. No time limit is specified for the sale of the property, but the lender is required within 12 months of foreclosure to list the property with a broker and to continue to advertise the property for sale, at least monthly thereafter. At any time more than six months after foreclosure, the lender may not reject or fail to act upon within 90 days a bona fide offer to purchase the property for fair consideration. Fair consideration is defined as outstanding principal plus interest and costs of holding the property.

The EPA rule also encourages, but does not require, the common practice of holders of security interests to undertake or require environmental inspections to minimize the risk that their loans will be secured by contaminated property. Such inspections are considered to be consistent with the security interest exemption and the lender is not considered to be participating in the management of the facility.

Bills were introduced in March 1991 in both the House and in the Senate which were designed to clarify lenders' liability under current environmental laws. The bill submitted by Representative John LaFalce (HR 1450)[10] is a revised version of legislation which he introduced in earlier congressional sessions. In introducing the bill, Mr. LaFalce stated that "testimony [at Small Business Committee hearings during the 101st Congress] from Government agencies, business community representatives, environmentalists, and bankers made clear that banks and other lending institutions are increasingly refusing loans to creditworthy small businesses that either use hazardous materials or are located in areas of possible contamination because of fears regarding potential liability generated by court action." For the most part the revision incorporates the provisions of the rule prepared by the EPA and would amend CERCLA of 1980 and RCRA of 1976. According to Mr. LaFalce, the House bill seeks to clarify the liability under those acts of lending institutions, fiduciaries, trustees, and others holding indicia of ownership primarily to protect a security interest in facilities subject to those environmental laws. At the same time he expects the revised legislation to address concerns of the environmental community by encouraging the conduct of environmental assessments, assuring that lenders and other parties who are directly responsible for environmental damage remain liable, encouraging lenders to take action to remedy environmental damage rather than walk away from their collateral, and requiring lenders foreclosing on property to move diligently to dispose of that property in order to remain within the bounds of the security exemption.

The Senate bill, sponsored by Senator Jake Garn (S 651),[11] is known as the Federal Deposit Insurance Improvement Act of 1991, and is similar to legislation that he introduced a year earlier. It amends the Federal Deposit Insurance Act to cap the liability of insured depository institutions and other mortgage lenders under federal statutes that impose strict liability for the release of hazardous materials, provided that the institution or company involved did not cause or contribute to the contamination. For insured depository institutions, the limitation applies to property acquired through foreclosure, held in a fiduciary capacity, or held as a lessor pursuant to a lease that is the functional equivalent of a loan. If a cleanup is conducted, the liability of the institution is limited to the actual benefit it receives, up to the fair market value of the property. The limitation does not apply if any institution or company, after acquisition of property through foreclosure or the termination of a lease agreement, fails to take reasonable steps to prevent the continued release of a hazardous substance after such release is discovered. To clarify the uncertainty created by the decision in the *Fleet Factors* case, the Senate bill also provides that an insured depository institution or mortgage lender will not be liable under federal law because they have the unexercised capacity to influence operations at or on property in which the institution has a security interest. The Senate bill would also protect federal banking and lending agencies against liability under state and federal laws for contamination on property acquired in connection with receivership or conservatorship activities, in connection with the provisions of a loan, or as a result of a civil or criminal proceeding, as long as they did not cause or contribute to the release of hazardous substances. The Senate bill has been incorporated into the banking reform bill as Title X which is under consideration in the Senate for approval.

The rules and regulations proposed by the EPA have received mixed reviews. Bankers and other lenders have indicated that they still want the level of certainty that only legislation would bring. Lenders fear that courts will not use an EPA rule to block private lawsuits brought by other interested parties against lenders. Environmental groups, on the other hand, claim that the banking industry's contention that it is facing enormous potential liability from hazardous waste sites is exaggerated. They oppose new legislation and assert that the threat of lenders' liability encourages lenders to investigate whether a company has a toxic-waste problem before agreeing to lend to it. Environmentalists expect this to make companies more vigilant about obeying environmental laws.

Contaminated sites in the Seventh District

Seventh District states have a long history of industrial activity and many of the cities in the region have grown into major manufacturing centers. With the activity and the growth have come the need to dispose of wastes that may be contaminated. It is such wastes that may result in liability for remedial action under CERCLA.

Banks in Seventh District states are very concerned with their potential liability under CERCLA. Overall, banks indicate a general unwillingness to lend to borrowers that are involved with hazardous materials. They cite the costs for both legal and investigative reviews which are now included in most commercial lending relationships where real property is taken as collateral. Due to the unsettled state of federal case law concerning the degree of participation in management that will subject a lender to liability for hazardous waste problems, banks are voluntarily absorbing costs for cleanup actions, releasing collateral coverage for existing loans, and not exercising rights as lien holders over real property to avoid claims by the EPA of more extensive liabilities. For existing credits, it is not unusual to have a small- to medium-sized company walk away from its debts, leaving the bank with possession and the problem of disposition of real property. In some cases the banks have refused to foreclose on properties so as to remove the potential determination of "owner or operator." This decision is obviously influenced by the underlying value of properties and the bank's assessment of the cost associated with claims by the EPA. This has not only affected lending relationships, but is increasingly posing problems for bank trust departments in instances where exercising fiduciary responsibilities may pull the institution into the "owner or operator" designation by the EPA.

The following are examples of the types of problems encountered by Seventh District banks.

A bank with a problem mortgage on a scrap yard recovered as much as possible from secondary collateral but walked away from their primary collateral and took a loss rather than take title to the scrap yard.

A 600 acre farm in trust was leased to a horsebreeder. Unfortunately, a relative of the breeder was a wastehauler. Two children found 3,700 barrels of toxic waste in the weeds on the property. At least $400,000 was spent in clean-up. Fortunately, the trust was large enough to cover the cost and no personal assets were attached.

A trust department holds a land contract which is currently in default. The trust officer suspects pollution on the site and is reluctant to take the property back. Likewise he is concerned about his fiduciary responsibility if he doesn't move to make the property income producing.

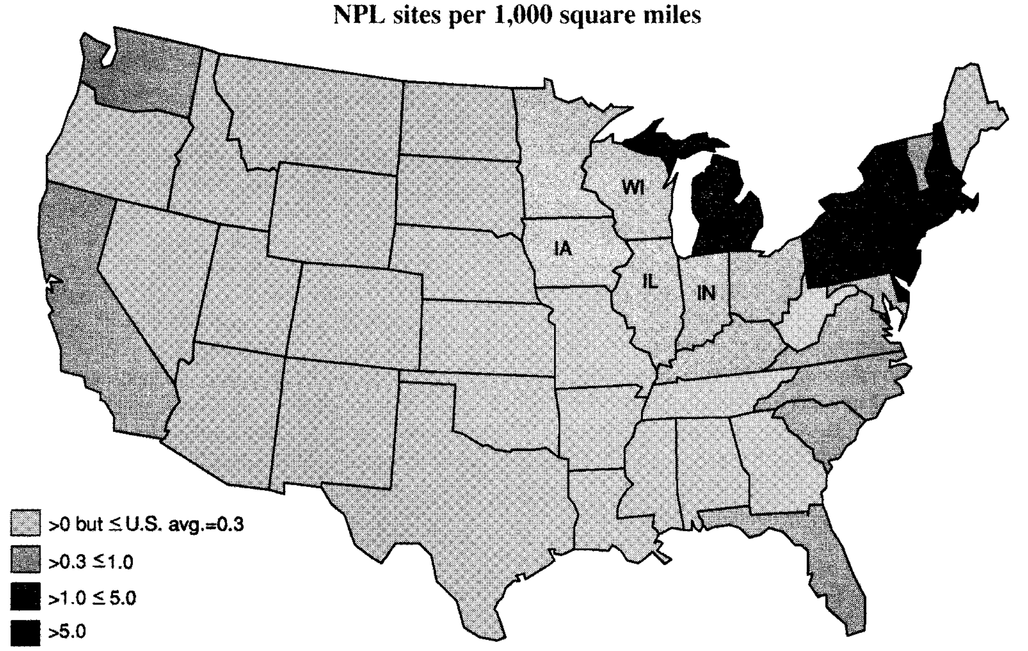
Some indication of the exposure to environmental risks in the Seventh District is provided in CERCLIS, the CERCLA Information System. CERCLIS is the EPA's comprehensive database and management system that contains the official inventory of CERCLA sites. It supports the EPA's site planning and tracking functions with data from the pre-remedial, remedial, removal, and enforcement sections of the Superfund program. Inclusion of a specific site or area in the CERCLIS data base

FIGURE 1

NPL sites

FIGURE 2

NPL sites per 1,000 square miles



does not represent a determination of any party's liability, nor does it represent a finding that any response action is necessary. About 50 percent of the CERCLIS sites are eliminated from further consideration at the first step of the evaluation process, the preliminary assessment. Sites that the EPA decides on the basis of available information do not warrant moving further in the site evaluation process are given a "No Further Response Action Planned" (NFRAP) designation in CERCLIS. Sites that the EPA believes pose environmental threats significant enough to warrant detailed evaluation for possible remedial action under Superfund are placed on the National Priorities List (NPL). The EPA uses a Hazard Ranking System (HRS) to identify sites for inclusion on the NPL. Between 2 and 7 percent of the CERCLIS sites evaluated are placed on the NPL.

Currently about 5,200 sites from Seventh District states are listed on CERCLIS. Of this number, 53 percent are designated as requiring no further action. Of the 2,473 remaining, 205 are on the National Priorities List. This represents 17 percent of the total 1,188 NPL sites in the United States. As shown in Figure 1, the number of NPL sites in the individual states ranges from 77 in Michigan to 20 in Iowa. The remaining 2,268 sites may require cleanup but are not considered serious enough to be currently eligible for the Superfund list.

As an indication of the extent of the risk of contaminated sites in individual states, the number of NPL sites per 1,000 square miles of land area is shown in Figure 2. Except for Michigan, the NPL ratio for each of the Seventh District states is moderately above the national average of 0.3. In Michigan there are 1.4 NPL sites per 1,000 square miles. The number of other sites on CERCLIS (not eligible for NPL) per 1,000 square miles is below the U.S. average of 4.4 in Wisconsin and Iowa and moderately above in Michigan, Illinois, and Indiana.

Conclusion

Environmental laws and regulations and recent court cases have introduced additional uncertainty and a new dimension to risk for financial institutions in lending. The apparent attempt to encourage lenders to require borrowers to comply with environmental laws and clean up industrial properties prior to granting a loan and during the life of the loan has introduced additional costs for the lender. In addition, lenders may find themselves liable for cleanup costs if they are adjudged to have participated in the management of a business that has contributed to the contamination of property that serves as collateral for a loan.

The additional uncertainty and costs affect the availability of credit as lenders are reluctant to make loans where the risks are largely unquantifiable. As a result, less funds are available for businesses where the risks of contamination are present either for operations or cleanup.

It is important for both the financial and environmental communities that the uncertainties as to the environmental liabilities associated with lending be clarified. Otherwise there exists a possible reduction in the availability of credit to any industry, area, or borrower that appears to present a risk of liability for hazardous substance removal.

FOOTNOTES

[1]42 U.S.C.A. §§9601-9657, Public Law 96-510 (Dec. 11, 1980); Public Law 99-499 (Oct. 17, 1986).

[2]45 B.R. 278 (Bkrtcy. 1985).

[3]15 *Environmental Law Reporter* 20922 (E.D.Pa. 1985)

[4]632 F.Supp. 573 (D.Md. 1986).

[5]712 F.Supp. 1193 (E.D.Pa. 1989); FR 14952 (April 12, 1991).

[6]732 F.Supp. 556 (W.D.Pa. 1989).

[7]901 F.2d 1550 (11th Cir. 1990), cert. denied, 111 S.Ct. 752 (1991).

[8]910 F.2d 668 (9th Cir. 1990). The Ninth Circuit claims to agree with the Eleventh Circuit decision in a footnote: "As did the Eleventh Circuit in *Fleet Factors*, we hold that a creditor must, as a threshold matter, exercise actual management authority before it can be held liable for action or inaction which results in the discharge of hazardous wastes. Merely having the power to get involved in management, but failing to exercise it, is not enough."

[9]FR 28797 (June 24, 1991).

[10]*U.S. Congressional Record*, 102d Congress, 1st Session, House of Representatives, Vol. 137, March 19, 1991, pp. E 987-8.

[11]*U.S. Congressional Record*, 102d Congress, 1st Session, Senate, Vol. 137, March 13, 1991, pp. S 3279-83.