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Actual vs. Apparent Influence: Towards a Standard for Lenders' CERCLA Liability

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As the 1990s began, two circuits diverged over the latest addition to the arsenal of lender liability: accountability for environmental cleanup costs of borrowers' spills. Though the Supreme Court declined in January 1991 to review this issue, three pending congressional bills and a rule proposed by the Environmental Protection Agency seek to address conflicting standards now in effect.

Paradoxically, lenders' potential for environmental liability becomes greater as they attempt to influence borrowers' waste management policies. Thus, even after the EPA addresses this increasingly troublesome area, lenders should reconsider carefully the terms of any loans secured by potential spill sites.

CERCLA Liability

Under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA),[1] strict liability is imposed for environmental cleanup costs over a wide range of actors and circumstances. Not only can CERCLA damages be assessed for both intentional disposals and accidental spills of hazardous materials, claims for such damages can be asserted against "any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of ..."[2]

"Owner or operator" of an onshore facility is defined to include current owners and operators, as well as those who "owned, operated or otherwise controlled activities at the facility" immediately before title to the facility was conveyed due to state or local government by bankruptcy, foreclosure, tax delinquency or abandonment.[3]

Grounds for Liability of Secured Creditors

"Alter ego" control over a subsidiary may justify piercing the veil and ascribing "operator" status to a parent hiding behind a subsidiary that is merely a "bogus shell."[4] A significantly smaller degree of control, however, suffices to subject a secured creditor to CERCLA liability for the spills of its borrower.

Under CERCLA, a secured creditor may evade the liability of an "owner or operator" by qualifying as "a person who, *without participating in the management of a . . . facility,* holds indicia of ownership primarily to protect his security interest in the . . . facility."[5] Thus, the lender who is cautious enough to hold such "indicia of ownership" as mortgages on the borrower's facilities must avoid "participating in the[ir] management."

As of August 1991, only the Ninth and Eleventh Circuits have elaborated on the degree of participation that will expose the lender to CERCLA liability, and these two circuits disagree.

District Court Decisions

The first decision on this issue, *United States v. Mirabile,*[6] held that for a secured creditor to be liable under CERCLA "it must, at a minimum, participate in the day-to-day operational aspects of the site."[7] Thus, the EPA was barred from recovering its cleanup costs from a mortgagee who had foreclosed on a paint manufacturing plant subsequently designated a hazardous waste site.

The court granted summary judgment to the mortgagee, which it saw as foreclosing, not in order to own the property, but to protect its security interest in its collateral.[8] In this context, the bank's securing the property, exhibiting it to potential buyers and investigating cleanup costs were not "participation" in the borrower's management but merely efforts to protect the property from further depreciation.[9]

Mirabile also granted summary judgment to a second lender whose loan documents had anticipated actual participation in management of the facility. The court determined that the lender's involvement was limited to "purely financial aspects" of the borrower's operations. This standard, however, would not permit the court to grant summary judgment to a third lender which had one of its loan officers on the borrower's advisory board and a second officer supervising the cash collateral accounts following the borrower's bankruptcy.

The next case to examine the environmental liability of a secured creditor under CERCLA seemed to eliminate *Mirabile's* focus on the degree of the creditor's involvement in the borrower's management. In *United States v. Maryland Bank & Trust Co.*,[10] the district court denied the bank's summary judgment motion against EPA action to recover cleanup costs. After foreclosing on its interest in the real estate, the bank acquired the property at a foreclosure sale. It was unclear whether the bank knew the property was contaminated; the borrower informed the authorities of contamination one year after the sale.

As strictly construed by the court, however, CERCLA's "owner and operator" exemption did not apply to the bank. At the time of cleanup the bank had not held indicia of ownership to protect its security interest, but to protect its investment held the land itself.[11] Thus, an exemption intended to preclude CERCLA liability for secured lenders in common law states, who hold title to the property until their loans are repaid, was inapplicable.[12] *Maryland Bank & Trust*, however, provided no guidance to lenders anticipating foreclosing on contaminated properties and immediately re-selling them.

Third Circuit Precedent

Two district court decisions from the Third Circuit support *Mirabile's* day-to-day standard of participation. In *U.S. v. Nicolet Inc.*,[13] the Eastern District of Pennsylvania declined to impose liability on a mortgagee that did not appear to have participated in the "managerial and operational aspects"[14] of an asbestos-contaminated facility. Four months later, in *Giudice v. BFG Electroplating and Manufacturing Co.. Inc.* [15] the Western District of Pennsylvania held that a secured lender seeking to protect its interest in a contaminated facility following a loan default was not an "owner or operator" of the facility before it bought the property at a foreclosure sale. Meeting with the borrower's managers, reviewing the borrower's accounts, personnel and inventory, assisting the borrower in its application for a small business administration loan, inspecting the property, referring a potential lessee to the borrowers, and arranging financing for the foreclosure sale of the property did not evidence the secured creditor's control over the borrower's operations, production or waste management.[16]

"... the most prudent course for a secured creditor is neither to acquire nor exert control over a borrower's management of a facility which has real or potential CERCLA liability."[38]

Giudice also agreed, however with *Maryland Bank & Trust* in exposing the secured lender to cleanup liability during the 18-month period between the lender's acquiring title to the property and conveying title to a third party.[17] Noting that the 1986 amendments to CERCLA had excluded from "owner and operator" liability, local and state governments that involuntarily acquire title to property, the court inferred that, in the absence of an analogous exemption, Congress intended to continue cleanup liability for lenders obtaining properties through foreclosure.[18]

Eleventh Circuit Interference of Control

In *United States v. Fleet Factors Corp.*,[19] defendant made an agreement to advance funds to a cloth printing facility against an assignment of the facility's accounts receivable. Fleet had taken as collateral a security interest in the facility and in its equipment, inventory and fixtures. After Fleet foreclosed and an auction of the debtor's property was held, the EPA found hundreds of drums of toxic chemicals at the site, as well as 44 truckloads of asbestos-containing material. The government sought to recover the $400,000 of cleanup costs from Fleet which held a deed of trust to protect its security interest in the facility.

The Eleventh Circuit declined to adopt the federal government's interpretation of CERCLA: that the terms of the exemption from liability be read literally to expose to CERCLA liability a secured creditor with any participation in the borrower's management. If the court found this interpretation too harsh on lenders "engaging in their normal course of business,"[20] it also rejected, as "too permissive towards secured creditors who are involved with toxic waste facilities,"[21] the borrower's *Mirabile*-type proposal, that only lenders who participate in the day-to-day management of the facility could be held liable.

Instead, *Fleet Factors* enunciated a new standard for imposing cleanup costs on the facility's secured creditor without finding them to be "operators." The court would assess cleanup costs against those creditors who had a sufficiently broad involvement with the debtor's management to support the inference that they could, if they chose, affect the borrower's hazardous waste disposal decisions.[22]

It remains unclear what degree of involvement with the borrower's management of a facility will be sufficient to support the *Fleet Factors* inference that the secured creditor could influence the borrower's disposal of waste. The Eleventh Circuit, however, noted that such control would "[g]enerally . . . be inferred from the extent of the creditor's involvement in the facility's financial management."[23] (Given the evidence that Fleet had actively controlled the facility's disposal of hazardous wastes, the *inference* of control had been unnecessary in its case.)

The court envisioned that, because potential creditors face the possibility of being held liable under CERCLA, they would evaluate the waste treatment systems of a potential debtor in arriving at the terms of the loan agreement. Since spills would threaten both the creditor's finances and the debtor's future loan arrangements, both borrower and lender will be compelled to comply with relevant environmental regulations. In particular, a secured creditor with a level of involvement in the debtor's facility sufficient to "anticipate losing its exemption from CERCLA liability . . . will have a strong incentive to address hazardous waste problems at the facility rather than studiously avoiding the investigation and amelioration of the hazard."[24]

Ninth Circuit Actual Daily Management

In *In re Bergsoe Metal Corporation*,[25] the Ninth Circuit moved away from the *Fleet Factors* "inference of influence" standard towards the "day-to-day participation" test. The Bergsoe lender, the Port of St. Helens, was a municipal corporation authorized to issue revenue bonds to promote industrial development in that area of Oregon. Under a sale-and-lease-back arrangement, the Port was to hold the title to the lead recycling plant under construction by Bergsoe until Bergsoe made all required rental payments to the bank holding the revenue bonds.

After its default on the leases and a failed workout agreement, but not before Oregon environmental authorities discovered contamination at the facility, Bergsoe was put in involuntary bankruptcy under Chapter 11. The Ninth Circuit, evaluating the claims against the Port for cleanup costs, first determined that the Port held "indicia of ownership" — the deed to the plant — merely to protect its security interest in the property. Then it addressed the thornier question of whether the Port had "participated in the management" of the facility, noting that *Fleet Factors* offered the only other circuit court guidance on this topic.

> ***"As of December 1990, 36 CERCLA suits had been brought against lenders, and the EPA had notified 60 lenders of their potential liability for cleanup costs."[32]***

Though it stopped short of espousing an explicit rule defining "participation in management," the court held that the secured creditor must engage in "*some* actual management of the facility" before it could be held liable as an owner or operator.[26] Since it could not find that the Port had exercised such control, the court declined to "engage in line drawing."[27]

The court was not impressed with the argument that by extending its loan the creditor had "negotiated and encouraged" the building of the facility. Secured creditors always contribute planning of large-scale projects, and necessarily "encourage" those that they finance.[28] Similarly, the court would not infer management of the facility from the lender's retention of the rights to inspect the premises and to re-enter and take possession upon foreclosure: almost all secured creditors reserve such rights.[29]

The *Bergsoe* court concluded, "Merely having the power to get involved in management, but not exercising it, is not enough" to constitute participation within the meaning of CERCLA. "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."[30]

Certiorari Denied

In January 1991 the Supreme Court denied Fleet Factors' petition for writ of certiorari, thus declining to review the disagreement between the *Fleet Factors* decision in the Eleventh Circuit and the *Bergsoe* decision in the Ninth Circuit. In its brief against certiorari, the Department of Justice contended that the case was not ripe for review, as the factual issue of the secured creditor's participation in management had been remanded to the trial court. Further, the government asserted that it had only pursued those lenders who had extensively participated in offending borrowers' managements.[31] The brief submitted by a coalition of banking institutions, however, indicated that the problem of lenders' cleanup liability would not be resolved soon. As of December 1990, 36 CERCLA suits had been brought against lenders, and the EPA had notified 60 lenders of their potential liability for cleanup costs.[32]

Congressional Solutions

As of August 1991, Congress is considering three bills which address the CERCLA liability of secured lenders. The "participation" standard of H.R. 1450 goes beyond even *Mirabile's* "day-to-day" test, and could more accurately be characterized as a "super-*Mirabile*" test. This bill would re-define "participation" under CERCLA to apply to those situations in which the secured creditor, through "the actual, direct and continual or recurrent exercise of managerial control" of the facility or vessel, "materially divests" the borrower of control.

A secured creditor's foreclosing on the property, or aiding the borrower's winding-down operations, would not constitute participation. Similarly, a creditor that had foreclosed on the facility would escape "owner or operator" liability under CERCLA so long as the creditor diligently attempted to sell the property on reasonable terms as quickly as possible; that is, so long as the creditor is attempting to protect the value of its security interest, rather than to invest in the property.

Under H.R. 1463 lenders holding indicia of ownership for the purpose of securing repayment would not be liable for cleanup costs for participating in management if they: 1) sold collateral; 2) conducted certain environmental audits; 3) while working to pass title of the facility, responsibly prevented hazardous spills; 4) had the capacity to affect the facility's waste management; or 5) engaged in workout activities such as restructuring or re-negotiation of a loan.

Introduced in the Senate, S.651 would revise the Federal Deposit Insurance Act, 12 U.S.C. §§ 1811 *et seq.*, to exempt insured depository institutions and mortgage lenders from any law, including CERCLA, that imposes strict liability for hazardous discharges from property acquired through foreclosure, held in a fiduciary capacity, held by a lessor pursuant to an extension of credit, or subject to financial control pursuant to the terms of an extension of credit.

Such exemptions, though, would not apply to a secured lender that caused the hazardous discharge, actively directs or conducts operations that result in the discharge, or knew about the hazardous conditions but failed to take "all reasonable actions necessary to prevent" the discharge. Also any creditor that benefited from a cleanup action instituted by the government or other party would be liable for the value of such benefit which could be no greater than the fair market value of the property.

Proposed EPA Rule

On June 24, 1991, the EPA published a proposed rule on this issue.[33] Under this proposal, as under *Bergsoe*, a secured creditor would not be subject to CERCLA liability as the operator of a facility in the borrower's possession unless the creditor has engaged in "actual participation in the management or operational affairs" of the borrower. Such participation is indicated where the secured creditor has effectively assumed responsibility for the borrower's policies, practices and procedures on waste disposal and hazardous substance handling.

The secured creditor is not exposed to CERCLA liability if it has "the mere capacity, ability or unexercised right to influence facility operations." Nor would it be considered participation for the lender to conduct or require an environmental inspection of the facility to ensure that the borrower is complying with the environmental statutes, to insist that the borrower clean up the facility before or during the loan, or to insert environmental warranties, covenants, and representations into loan and contract documents.

Under the EPA draft rule, the lender may engage in "workout" activities, such as restructuring or renegotiating a loan or providing specific financial or operational advice, without participating in the borrower's management, so long as the workout is structured to protect and preserve the lender's security interest, and the lender allows the borrower to maintain control over the operations of the facility, particularly with respect to hazardous materials. The EPA draft, however, reminds secured creditors that even if they are not deemed to be participating in

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management they may be independently liable under such provisions of CERCLA as those covering transporters of, or contractors for the transport of, hazardous substances.[34]

The EPA rule would address *Maryland Bank & Trust Co.'s* unresolved foreclosure issue by applying the secured creditor exemption to those situations in which the creditor has foreclosed on a loan "primarily to protect its security interest." The secured creditor, while preventing and minimizing the release of hazardous materials, should wind up the borrower's operations on the acquired facility or take other appropriate action to ensure that the secured asset's value is maximized. (The creditor may not be liable for spills that occur under these circumstances.)

The foreclosing creditor must take reasonable steps to sell the property. After six months from the foreclosure date, the creditor cannot ignore a written *bona fide* firm offer of a value at least that of the borrower's outstanding obligation. If the creditor does not divest itself of the property within a reasonable period, it may lose the exemption. The EPA, however, declines to suggest the length of a reasonable period, noting only that *Maryland Bank and Trust* held four years was too long a period while *Mirabile* found four months acceptable.

The comment period on the EPA's proposed rule expired on July 24, 1991. The proposal will now be promulgated and, if application is made within 90 days, will be subject to review by the U.S. Court of Appeals for the District of Columbia Circuit.

INDETERMINACY

Even under the EPA rule as proposed, the CERCLA liability of a secured creditor is far from clear. The circumstances under which a lender will be held liable as an "owner or operator" for participating in management can only be described as fact-sensitive. Third parties still are able to sue lenders for recovery of cleanup costs.[35] Questions persist about the duty of the lender to address environmental problems during the "workout" stage.[36] Finally, the cost of uncertainty and of increased environmental monitoring has led to higher interest rates and transaction costs, with debatable effects for the banking industry.[37]

Until these and other issues are resolved and their ramifications clarified, the most prudent course for a secured creditor is neither to acquire nor exert control over a borrower's management of a facility which has real or potential CERCLA liability.[38] If loans to such borrowers are made, the documents should explicitly minimize any control given to the lender over the borrower's management decisions, particularly in the environmental context. If such control must be provided for, it should not be exercised by the lender.

In the spreading wake of *Fleet Factors* and *Bergsoe,* secured lenders may best protect themselves by adjusting the terms of loans to reflect the lenders' potential cleanup liability. In addition, lenders may attempt to substitute alternate security, such as guarantees, for facilities of environmental concern that currently collateralize loans.

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FOOTNOTES

1 Pub. L. No. 96-510, 94 Stat. 2767 (codified in part at 42 U.S.C. § 9601-9657 (1982)), amended by Superfund Amendments and Re-authorization Act of 1986, Pub. L. No. 99-499, 100 Stat. 1613.
2 Section 107(a)(2), 42 U.S.C. § 9607(a)(2).
3 42 U.S.C. § 9601(20)(A)(ii), (iii).
4 *Joslyn Mfg. Co. v. T.L. James & Co. Inc.*, 893 F.2d 80, 84 (5th Cir. 1990).
5 42 U.S.C. § 9601(20)(A) *(emphasis added).*
6 5 Envtl. L. Rep. (Envtl. L. Inst.) 20,994 (Sept. 4, 1985).
7 *Id.* at 20,996.
8 *Id.*
9 *Id.*
10 632 F. Supp. 573 (D.Md. 1986).
11 *Id.* at 579.
12 *Id.*
13 29 Env't. Rep. Cas. (BNA) 1851 (E.D.Pa. 1989).
14 *Id.* at 1860.
15 732 F. Supp. 556 (W.D.Pa.1989).
16 *Id.* at 562.
17 *Id.* at 563.
18 *Id.*
19 901 F.2d 1550 (11th Cir. 1990).
20 *Id.* at 1556.
21 *Id.* at 1557.
22 *Id.* at 1558.
23 *Id.* at 1559, n. 13.
24 *Id.* at 1559.
25 910 F.2d 668 (9th Cir. (1990).
26 910 F.2d at 672.
27 *Id.*
28 *Id.*
29 *Id.*
30 *Id.* at 673, n. 3.
31 Quoted in *Lender Liability News*, Vol. 2 No.14 at p. 5 (1991).
32 *Id.*
33 56 F.R. 28798 (June 24, 1991).
34 42 U.S.C. § 607 (a)(3)-(4).
35 *EPA Says Creditors Using Standard Cleanup Practices Exempt from Liability,* BNA's Banking Report, Vol. 56, No. 8, p.333.
36 Rosemarin, *Lenders Still Face Cleanup Issues Under Revised Liability Rules,* The National Law Journal, March 25, 1991, p.24, at p. 25.
37 Note, *Limiting Liability of the Passive Lender Under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980,* 26 Tulsa L.J. 75, (1990).
38 Ironically, liability for cleanup costs might be imposed on a lender who has actively insisted on better management of hazardous waste, while a laissez-faire attitude towards even the most negligent waste management might insulate a lender from liability.