

ENVIRONMENTAL LIABILITY:

A LENDER'S PERSPECTIVE

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PREFACE

This study was undertaken due to my interest in the effect environmental legislation is expected to have on the banking industry in the future. Having chosen banking as a career path, and with the hope of being a lender, I have been intrigued at the way that financial institutions have responded to the liability issue that has recently presented itself. Congress and the EPA have been negotiating for months to achieve an acceptable level of protection for banks, whose aversion to contaminated real estate has begun to impact the economy. On April 24, 1992, the White House announced a package proposal, a portion of which shields banks from liability when involved in lending for projects involving Superfund sites. Whether this proposal is as protective as it appears and whether it escapes the legislative bargaining table unscathed remains to be seen.

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CHAPTER I

INTRODUCTION

The issue of environmental responsibility has become a major topic of discussion recently in credit departments in banks across the country. This discussion centers not around a hole in the ozone, rain forest depletion or recycling, but around business practices that permanently impair properties.

Legislation in the mid to late nineteen eighties has undertaken cleanup action and placement of responsibility for the damage. The problem is that, in many cases, the damage was done years ago by a company no longer in existence. Disposal practices once thought perfectly safe are being discovered to be unacceptable. Or perhaps the current owner cannot afford to clean up the mess. Sometimes the party actually responsible for the problem is not identifiable.

Lenders are exposed in several different ways. The most obvious way for a financial institution to be adjudged liable is through ownership via foreclosure. Another equally serious possibility is that the borrower is unable to repay his debt due to the costs of cleanup. A third possibility is that the collateral a lender has depended on for repayment is worthless due to contamination. And a fourth danger is

that of contributory negligence, where the bank may be blamed by virtue of its having financed the generator.

There are a number of different avenues that may be explored in solving the problem. These include property assessments, policies and covenants in the loan documents. Most commonly, all three will be employed. Lenders are only now beginning to set out formal policy with regard to environmental precautions and guidelines. It has not proven to be an easy task; the issues are broad and the possible problems are of an even wider range. Full support of upper management is required, and enforcement often requires a "top-down" mentality.

This paper seeks to briefly discuss the laws which have precipitated this issue and the impacts on both industry and banking. It will explore areas of major physical risk and what banks can do to be as fully informed as possible, as well as lender's risk and the loan structure that might aid in defending it in the event of an environmental predicament.

CHAPTER II

ENVIRONMENTAL LEGISLATION AND REGULATION

Resource Conservation and Recovery Act of 1976

The Resource Conservation and Recovery Act of 1976 (RCRA) is actually an amendment to the Solid Waste Disposal Act. Congress decided that too much of a valuable natural resource, land, was being used up in an effort to dispose of waste. Much of the waste itself had the potential to be reprocessed and reused. Additionally, continuing technological progress had in the past and would continue to result in both an increase in the amount and variability of the waste created. Congress also stated that waste management problems would only get worse as our population grew and that it was necessary to find an alternative to dumping, in order to maintain both human health and environmental integrity.

The Congress' stated objective with this act is to "...promote the protection of health and the environment and to conserve valuable materials and energy." The act provides for this via several means:

Provision of technical and financial assistance for the development of solid waste management plans (recovery and conservation systems) to promote improved solid waste management techniques, new and improved methods of collection, separation and recovery of solid waste and environmentally safe disposal of nonrecoverable residues.

Provision of training grants involving the design, operation and maintenance of solid waste disposal systems.

Prohibition of future open dumping and conversion of existing open dumps.

Assurance that hazardous waste and management practices are conducted to protect human health and the environment.

Requirement that hazardous waste be managed properly in the first place, thereby reducing the need for future corrective action.

Minimization of hazardous waste generation and land disposal by encouraging process substitution, materials recovery, properly conducted recycling and reuse and treatment.

Establishment of a federal-state liaison to carry out the act and assist states in authorizing sub-programs under subtitle C (hazardous waste management).

Provision of guidelines for collection, transportation, separation, recovery and disposal practices and systems.

Promotion of a national research and development program for improved management and resource conservation techniques.

Promotion of the demonstration, construction and application of solid waste management, resource recovery and conservation systems which preserve and enhance the quality of air, land and water resources.

Establishment of a cooperative effort among all levels of government and private enterprise in order to recover valuable energy and materials from solid waste.

RCRA further authorizes legislative authority to access and conduct inspections of hazardous waste handling facilities. Inspection purpose, scope and guidelines are detailed in the text of the regulation. (Hall et al., RCRA various)

Solid Waste Disposal Act Amendment of 1980

The Solid Waste Disposal Act, among its many points, established the National Advisory Commission on Resource Conservation and Recovery, a member of the Executive branch of the government. Its purpose was to

assess the extent to which programs for recovery were being realized; review existing and proposed guidelines and regulations; determine economic impact of recovery, including the availability of markets for recovered energy; identify and address any impediments; and evaluate the status of systems in place (Hall et al., RCRA various).

Used Oil Recycling Act of 1980

This act addresses the value in recycling used oil and the threat it poses to health and environment if disposed of improperly. This act requests a study from the EPA assessing the problems associated with the disposal and reuse of oil, addressing the collection cycle of used oil prior to handling, analyzing supply and demand (present and future) of both used oil products and virgin crude, comparing re-refining versus other reuses, and recommending environmentally sound and economically feasible policies (Hall et al., RCRA various).

Hazardous and Solid Waste Amendments of 1984

These amendments undertook to inform and educate hazardous waste generators of their responsibilities. It also enacted a census of small quantity (less than 1000 kilograms/month) generators and subsequent evaluation of [then] current manifest systems on these generators. Licensing alternatives and various ways to ease the administrative burden on small quantity generators, together with division of duty between the Department of Transportation (DOT) and the EPA were discussed. The act also directed a detailed inventory of all U.S. wells injecting hazardous waste. The act's final contribution was the

establishment of the National Groundwater Commission, whose responsibilities were many and varied (Hall et al., RCRA various).

Toxic Substances Control Act of 1977

This legislation (TSCA) resulted from congressional opinion that both humans and the environment are increasingly exposed to a plethora of chemical substances and mixtures, some of which may present an unreasonable risk. Also, the consensus was that there was an additional need for research of substances before they're unleashed on the public sector. Subsequent policy mandated the development of data to address both the regulation and prevention issues, with the parties responsible for gathering the data being those who manufacture and process such chemical substances and mixtures. Additionally, congress noted the need for authority to regulate substances both inter- and intrastate. TSCA differs from regulation such as the Clean Air Act and the Federal Water Pollution Control Act in that it puts a heavy emphasis on testing and regulation of chemicals before the substance is introduced to commerce. In short, the intent of the act was to assure that innovation and commerce in chemical substances and mixtures did not present an unreasonable risk of injury to health or the environment, while exercising this authority in such a way as to avoid impeding or creating unnecessary economic barriers to technological innovation (Conner et al. various).

Comprehensive Environmental Response
Compensation and Liability Act

The Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA) was concocted as a federal response to uncontrolled releases of "hazardous substances" from any vessel or facility, including those both onshore and offshore. The act was prompted by the realization that RCRA did not address regulation for inactive sites, contamination from abandoned facilities or releases from any vessel or facility not subject to RCRA standards. CERCLA is not an example of extensive regulation; rather, it imposes reporting and cleanup obligations on the private sector. Its implications cast the shadow of liability over a very broad class of potentially responsible parties.

"Responsible parties" include present or former owners or operators of disposal sites, transporters responsible for site selection, and the generator of the waste who sent it to the site. In cases where high quantities of waste have accumulated over a period of time, the act allows for retroactive joint and several liability of parties (Hall et al. Superfund various).

The federal government has the authority and the financial backing of the "Superfund" to clean up listed hazardous waste substances. Additionally, it may direct cleanup of other, non-listed substances that it determines "may present an imminent and substantial danger to the public health or welfare." (CERCLA 1980) The government can either order the owners to undertake the cleanup or can do it themselves with Superfund money and bill the owners. Persons responsible for the release of hazardous waste are responsible for all costs of cleanup and

restoration. Only when a financially responsible party cannot be located will the Fund remain unreimbursed. An additional restriction is that in the case of non-listed substances, the owners may not be billed for work the EPA undertakes; the agency can merely direct the owners to do the work (Hall et al. Superfund various).

The act also takes some proactive measures to ensure future fiscal integrity of the Fund. One such measure is the requirement that owners and operators of hazardous waste handling facilities must show evidence of financial responsibility indicating that the responsible owner, operator or transporter can afford to pay the cost of removing any contaminants and restoring damaged resources (Hall et al. Superfund various). One example is the EPA's requirement that owners of underground storage tanks show at least \$1 million in financial capacity using either insurance or some other asset by October of 1991 (Busch 51).

Amendments to CERCLA

Superfund Amendments and Reauthorization Act (SARA) These amendments to CERCLA were passed in 1986 and served to expand the structure and add detail to the text of the original (Hall et al. Superfund various). SARA defined cleanup standards and set forth a preference for a permanent remedy, or one in which treatment is used to actually physically reduce the volume or toxicity of the waste going forward. The process of hazardous waste cleanup is addressed in specific, and may reflect congressional dissatisfaction with the [lack of] speed and scope of the EPA's activities to date under Superfund. SARA set new deadlines for evaluation of sites, placing them on the

National Priorities List (NPL) and undertaking response action. It added the study of health effects to the requirements for studies on sites listed on the NPL, specified procedures for settlement negotiations and added a new title on emergency planning and community right-to-know. Additionally, new insurance provisions were added, with authorization to form risk retention groups and pollution liability insurance purchasing groups to provide some relief from the collapse of the environmental insurance market.

Both CERCLA and SARA are intended to provide minimum standards for the individual states. Superfund does not pre-empt any state from imposing additional liability requirements, and SARA requires that state standards must be considered in determining the appropriate degree of cleanup for a particular site. Federal facilities are subject to state laws regarding the management and removal of hazardous waste. Finally, no federal, state or local permit is required to undertake any Superfund response action which is conducted on site (Hall et al. Superfund various).

Innocent Landowner Defense Act The Innocent Landowner Defense Act, which is incorporated in SARA, addressed the issue of the "responsible party." It excluded from this group parties who: did not know the property was contaminated at the time of acquisition; reacted responsibly to the contaminants when found; and had made reasonable inquiries into the past uses of the property prior to acquisition to determine the contamination of the property (O'Brien and Frank A9).

Asbestos Hazard Emergency Response Act of 1986 This act addresses asbestos specifically in its capacity as a hazardous waste. It is most probably addressed directly due to the widespread nature of its existence in school buildings as well as public and commercial buildings. The act called for standardization in the identification of asbestos containing materials and implementation of appropriate response actions. The existing situation was that some owners had taken action to remove asbestos without knowing whether their activities were necessary, adequate or safe. Others had undertaken no action at all. The act provided for Federal inspection regulations, acceptable response action and reinspection of sites, especially as related to public school buildings. Also, direction was given to conduct further studies to determine the extent of the threat to human health posed by asbestos in public and commercial buildings, as well as appropriate responses.

Generally, asbestos which is encapsulated in a form such as ceiling or floor tile does not pose an immediate threat. It is only when the material is disturbed and unencapsulated, as when being removed, that risk occurs. Accreditation and training requirements for abatement procedures have also been created and enforced.

Proposed Environmental Protection
Agency Ruling 1991

The EPA's proposed ruling, announced June 1991 and experiencing change up to the present, comes in response to some difficulties, perhaps unforeseen by those who drafted CERCLA, which have resulted from the wording of that legislation. Although CERCLA and SARA were intended to offer banks some protection from liability by excluding from

the list of responsible parties any "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" (42 USC 9601 (20) (A)), the ambiguity of these qualifications has led to widely varied interpretations. Banks have not been protected as a result, as can be seen in the precedent setting Fleet Factors case, discussed in the following section.

The EPA's proposed ruling was catalyzed by the realization that banks were shying away from business that even remotely suggested the possibility of environmental involvement. There has even been speculation that this trend has been a contributor to the current credit shortage (Feeney 1). In the words of F. Henry Habicht, Deputy Administrator of the EPA, the new rule would "allow lending institutions to protect their financial interests in properties...held as collateral, while it assumes that those responsible for contamination are held responsible." (EPA Proposes Lender Liability Rule 299).

One of the more important actions of the proposal is that it undertakes to define the three crucial but ambiguous phrases from CERCLA: "indicia of ownership"; "primarily to protect a security interest"; and "participation in the management of a facility".

The EPA's proposed rule defines indicia of ownership as "evidence of interests in real or personal property held as security for a loan or other obligation, including full title to real or personal property acquired incident to foreclosure and its equivalents" (Jones et al.). This includes mortgages, deeds of trust, title as a result of foreclosure and other ownership interests. The most significant point

made is the continuance of secured creditor exemption after foreclosure, a right not previously available.

Limitations of the exclusion under foreclosure would be limited to those properties held "primarily to protect a security interest," or in other words, to ensure payment or guarantee performance of an obligation. Among interests not protected are those such as a lease or consignment not considered a secured transaction; an interest in property held for investment purposes; or a general interest held for any reason other than protection of a security interest in real or personal property (Jones et al.). Three tests of "held for investment" are: 1) the lender outbids or refuses bids from parties offering fair consideration (fair consideration is deemed to exist if the bidder offers at least outstanding principal balance plus interest and costs associated with foreclosure); 2) a lender, given the option to terminate operations and liquidate or continue operations to protect value, must document that the collateral's value in an ongoing operation exceeds that in a liquidation; and 3) the lender must take specific action to dispose of the property within twelve months of foreclosure (Jones et al.).

In the past, as in Fleet Factors, rulings have been handed down based on the lender's capacity to influence environmental treatment administered by its customers, rather than actual participation in management decisions. The proposed rule seeks to address this issue by defining participation in the management of a facility as "actual participation in the management or operational affairs by the holder of the security interest." In this definition is the inherent fact that the presence of an unexercised ability to influence operations is not

significant to nullify the protection offered by the secured creditor exemption. This proposal even goes so far as to list specific activities that may be undertaken without being considered participation.

Environmental audits are allowed, but not required, to qualify for exemption. Therefore liability cannot, as in the past, be predicated on the failure to conduct an audit.

Actions to work out loans have historically been the cause of the bulk of the confusion. The following are expressly permitted:

- requiring borrower to clean up property;
- requiring assurance of compliance by borrower with environmental laws;
- monitoring/inspecting borrower's business, financial condition or collateral;
- reasonably policing loan or requiring compliance with the law;
- restructuring or renegotiating the loan;
- increasing the interest rate;
- extending the loan term;
- giving specific or general financial advice;
- counseling the borrower to the extent reasonably necessary to protect the security interest;
- acting to the extent reasonably necessary to protect the security interest (Jones et al.).

There are two areas not addressed in the 1991 proposal. One is trustee liability, which means that an institution holding real property in trust may not be covered under the secured creditor exemption. The other area omitted is the effect on banks as a result of suits brought by private parties, or those other than the EPA (Scranton 19).

Fleet Factors Case Illustration

One of the most widely publicized recent cases in environmental liability is the U.S. vs. Fleet Factors Corp. case. It's illustration will present a clearer picture of Superfund's shortcomings and the impetus for the 1991 EPA proposal. The facts follow.

Fleet Factors Corp. (FF) advanced funds to Swainsboro Print Works (SPW) against the assignment of SPW's accounts receivable, and also took as collateral an interest in SPW's facility, equipment, inventory and fixtures (Simons 27). SPW later filed Chapter 11 bankruptcy, but FF continued advancing until SPW's debt exceeded the value of the receivables. Upon discontinuance of advances, SPW was forced to cease operations and begin liquidation, with FF collecting the receivables. Chapter 11 became Chapter 7, a trustee was appointed and FF was allowed to foreclose on its security interest in inventory and equipment. FF did not foreclose on the facility, but hired an auctioneer to sell the inventory and equipment on an "as is, where is" basis. FF also alleges that they hired a company to remove unsold equipment. Subsequently, however, the EPA spent \$400M to remove 45 truckloads of asbestos and other hazardous waste (Simons 27).

In its suit, the EPA alleged that FF:

- Required SPW to seek its approval before shipping to customers;
- Established the price for excess inventory;
- Dictated when and to whom the finished goods should be shipped;
- Determined when employees should be laid off;
- Supervised the activity of the office administrator;
- Received and processed SPW's employment tax forms;
- Controlled access to the facility;
- Contracted with the auctioneer to dispose of the fixtures and equipment at SPW;
- Should be held responsible for any damage done during and after the auction (Simons 27).

Originally, the district court followed a precedent set in another case, U.S. vs. Mirabile, which interpreted the secured creditor exemption as permitting lenders to participate in financial decisions of facilities. Thus, the court ruled that FF had no liability under CERCLA with regard to activities prior to the auction. There was some

dispute, however, as to FF's responsibility during and after the equipment auction. Both parties, the EPA and FF, took an appeal to the Eleventh Circuit Court.

The higher court reversed the ruling, rejecting the interpretation allowing lenders to participate in broad financial decisions, and found that a secured creditor is liable for cleanup costs by virtue of participation in financial management to the extent it has the capacity to influence the corporation's treatment of toxic waste (Simons 29).

Since the issues arose in cross-summary judgment motions, the Eleventh Circuit did not make a final determination (Simons 29). Subsequently, the U.S. Supreme Court has refused to hear the case and remanded it back to Atlanta's district court. Suggestion has been made that a legislative solution to the problem with the Congress as a forum for arguments may be an appropriate treatment for the problem (Garsson and Kleege 1,7).

Ironically, the Eleventh Circuit Court was of the opinion that it's ruling should not evoke fear of CERCLA on the part of lenders of "occasional or discrete" involvement in financial decisions that serve to protect their security interest. The court also stated it saw no reason for the ruling to inspire disincentives to extend credit to businesses with potential hazardous waste problems. Instead, the court believed that its opinion would encourage thorough (and costly) investigation of the waste treatment systems and policies of potential debtors, factor waste treatment deficiencies or the possibilities thereof into the loan agreement to offset additional risk, and implement a continual monitoring of systems and compliance. Paradoxically, the same power the court suggests lenders use in monitoring and enforcing

compliance and enacting cleanup is the very type of management participation that results in the liability it is intended to avoid (Simons 30). According to the Eleventh Circuit:

"The scope of the secured creditor exemption is not determined by whether the creditor's activity was taken to protect its security interest. What is relevant is the nature and extent of the creditor's involvement in the facility, not its motive. To hold otherwise would enable secured creditors to take indifferent and irresponsible actions toward their debtors' hazardous waste with impunity by incanting that they were protecting their security interests." (Simons 30).

CHAPTER III

IMPACT OF ENVIRONMENTAL LEGISLATION AND REGULATION ON INDUSTRY AND BANKING

Industry Impact

Requirements for Financing

Environmental regulation has the potential to impact virtually any industry, any lender, any company. Situations span a broad range, from the manufacturer who outputs toxins as a by-product and knowingly misdisposes of them, to the energy products company who disposes of its waste in a perfectly acceptable manner which 20 years later is discovered to be less than acceptable, to the small business that acquires a site formerly used as a gas station. The reasons for the many gray areas in the law are easily seen. Hazards are not always obvious at the outset of a credit decision. Substances not on the EPA list now may be on it in the future, leaving lenders and borrowers in the lurch for not properly treating the material all along. Yet who can know these things? The medical profession, oil and gas, commercial real estate and residential real estate are just a few areas which are heavily affected. Any business acquiring real property must take extensive measures to ensure no abuse of the property in prior years. The repercussions on credit are as broad as the causes. Any property held as collateral and foreclosed upon may bring with it extensive liability.

Credit extended to a company responsible for producing hazardous waste may be construed as contributory negligence. A company willing to pay its own cleanup costs may be forced into bankruptcy as a result, leaving the bank with the choice of losing principal and interest by not foreclosing or facing liability by foreclosing to recoup its investment.

Ways to Make "Dirty" Sites Profitable and Resalable

Two facts stand out with regard to real estate transactions: 1) almost every piece of industrial, commercial and agricultural property will have some contamination; and 2) almost all hazardous waste problems are manageable. (McGregor 48) The solution should be approached from two directions. First, the parties must know the scope of the contamination, the liability implications, and the proper procedures for physical cure. From the other end, documents should be written that specifically allocate financial responsibility, clean up duties, and acknowledge the owner's ability to handle the financial burden (McGregor 48). This is one way to increase the comfort level involved in problem solution. Actual cleanup, of course, will depend upon the nature of the problem. Asbestos abatement, for example, is a far different process than neutralizing the effects of a leaking underground storage tank. It is worthwhile to note some of the more common solutions as well as some new technologies, however.

If an underground storage tank (UST) is found to have leaked, soil ventilation and air-stripping equipment may be employed to remove hydrocarbons from the soil and groundwater. Asbestos is abated by a certified contractor who carts the material out using safety equipment,

and while the area is off limits to non-abatement personnel. Chemical spills must be neutralized differently, depending upon what chemicals are involved.

One of the newer and most promising methods for soil recovery is bioremediation. This group of technologies, different depending on what substance needs to be removed and where it is located, involve the use of microorganisms to facilitate the degradation of hazardous waste. This method has the potential to replace thermal treatment, vapor extraction, chemical destruction and landfilling. Although to date the method has been most successful in relation to biodegradable, organic substances, the technologies can be applied to most types of contaminated media. Bioremediation offers an alternative which is cost effective, environmentally safe and readily usable in the field (Autry and Shearon 21).

For soils which cannot be readily evacuated, "in-situ" applications are used. This method is used for deeply contaminated soil or soil that cannot be removed by virtue of its location (e.g. under a building). The technique uses the addition of nutrients, oxygen sources and microorganisms into the soil to allow for percolation through the contaminated soil. In-situ bioremediation is largely anaerobic and thus somewhat slower in processing time than its alternative method, "ex-situ" application (Autry and Shearon 21,22).

Ex-situ application uses the same basic ingredients as in-situ, except that the contaminated soil is excavated and treated off site. This allows the soil to be blended regularly and exposed to oxygen during the remediation process. Aerobic bacterial growth and biodegradation rates are usually faster than anaerobic ones (Autry and

Shearon 22,25). There are a multitude of factors involved in these applications which are beyond the scope of this paper. However, the importance of this developing technology in reducing risk through providing a low cost solution is not to be missed.

Financing Alternatives

Businesses in industries where environmental contamination is an obvious factor may be, now or in the near future, faced with the difficulty of obtaining financing from liability-shy financial institutions. In the long term, lenders will develop policies and guidelines which, over time, will serve to provide a comfort with lending to all but, perhaps, the most prolific waste producers. In the mean time, however, organizations with borrowing needs, especially where real estate is concerned, may be forced to look for other ways to finance their businesses.

Generally, working capital lines of credit are secured with current assets, such as accounts receivable and inventory. Often, an interest in equipment is taken as well, just to provide cushion. These types of transactions are not normally thought of as being environmentally risky. As discussed in the Fleet Factors case, however, recovery of equipment coupled with some elements of business activity can result in liability. Unavailability of short term credit may force companies to seek out alternatives for working capital funding. These might include: heightening efficiency of their business by collecting receivables faster, stretching payables and shortening inventory holding periods. This action is healthier than borrowing and, providing the company is capable of making these adjustments, will

result in stronger liquidity, lower leverage and better profits. If the organization cannot create its own short term funding, they may pursue borrowing capacity from an "asset based lender" (ABL). ABLs have long been willing to take on more risk than banks and specialize in borrowing base (that is, lending on current assets) lending.

Business activities requiring longer term credit, such as fixed asset acquisitions, real estate purchases or takeover/merger strategies face a different set of problems. These transactions, especially the latter two, are quite often secured with real property. In the case of mergers and acquisitions, the danger may be doubled if the company being acquired produces questionable waste or is situated on a property with a cloudy history. In these cases, extensive due diligence is necessary. This process is involved and potentially expensive, but short of raising capital through sale of stock, bonds or some other market transaction, alternatives are limited.

Banking Impact

Bank Regulatory Issues

At the current time, bank regulators have not set forth a formal policy beyond that already standing in legislation such as CERCLA and RCRA. The banks are expected to perform reasonable due diligence, the subsistence of which is discussed later. Thorough documentation is required of all investigations ordered, what they consist of and the results.

Policy Impact for Banks

Banks, as individual institutions, have long had an awareness of the need for knowledge of the current operations of their customers with regard to environmental impact. Never, though, have they stood guard as they are beginning to do today. Policies are being developed and guidelines set in most major institutions. Whether policy is set as a prevention technique or as an emergency response to a problem, whether that policy is cursory or detailed and which specific issues are addressed will vary according to region, lending concentrations and the extent and seriousness of past problems. For the purposes of this paper, a policy typical of a major regional bank in the mid-south will be examined and used as a template for general policies and procedures that may be useful. Henceforth, the bank in question will be referred to as "the Bank."

The Bank's policy is general in nature and broad in scope, allowing for tailoring to different loan needs and industries. Additionally, it should be noted that the Bank shifts the weight of curing any situation uncovered in a pre-loan survey to the shoulders of the potential borrower. The borrower may then, at his discretion, negotiate terms with the present owner/seller if applicable. The Bank will refrain from lending until the site is certified clean. In the case of liabilities discovered with an existing customer, the Bank can only request that the problem be cured. Unless there is an environmental liability default phrase in the loan agreement, there is little or no action beyond the request that can take place.

At the outset of a prospect's request for credit, account officers routinely complete a checklist such as the one found in Figure 1 on the

following pages. Any business triggering the appropriate signals is then analyzed more fully to ascertain whether it is a feasible prospect to pursue further.

Loan types routinely requiring site reviews (Phase I assessments) are:

- purchase of residential property built prior to 1962;
- home improvement on homes built prior to 1962;
- purchase of raw land for residential or commercial development;
- purchase or renovation of commercial property, including apartments, built prior to 1982;
- manufacturing facilities;
- storage yards;
- warehouses;
- oil and/or gas drilling sites;
- capital improvements;
- feedlots;
- agricultural facilities such as elevators;
- dealer/floorplan, if facilities are part of collateral package;
- sale of petroleum or chemicals;
- contractors and subcontractors;
- salvage and scrap operations.

The Bank's policy also includes a list of bank approved environmental assessment agencies and minimum requirements for Phase I and II audits. These are addressed in Chapter IV, "Lender Liability and Responsibility Created by Environmental Legislation." Additionally, occasional site visits by the Bank's asset lending staff may be required to ensure continued adherence to regulatory guidelines, in the case of an ongoing operation involving hazardous waste generation or disposal.

Within the Bank, discussion continues as to minimum allowable levels of waste. Credit personnel may think even small amounts are unacceptable, but lending staff contend for impracticality of turning down an otherwise good credit for what might be considered a relatively minor problem.

COMMERCIAL LENDING POLICY

NOTE: Use of this form is intended as a guide only and not all questions or issues will apply in every situation.

INTERNAL ENVIRONMENTAL SITE CHECKLIST AND LOAN STRUCTURE WORKSHEET

1. Statement of industry/activity to be carried out or has been carried out on the site: SIC Code
2. Summary comments derived from actual site inspection:
3. Opinion of account officer on whether or not owner/operator of site is aware of potential environmental liability and seems to have an active concern about the subject:
4. Did the site inspection or comments from management^t reveal any actual or potential residuals or waste products produced by customer's operations? Yes No If yes, explain
5. Ask if there are any required local state and federal permits and estimate of costs needed to comply with requirements:
6. Ask if the firm/site has an accident history, past, present, cleanup results, any regulatory agency sanctions or pending actions?
7. Ask if the company or the site is included on any federal, state or local list of existing or "potential responsible parties" or on lists of potentially contaminated sites? If yes, explain
8. Ask if there are any known legal or enforcement actions presently in process or pending against the customers or attached to the site that involve environmental hazard liability?

Figure 1. Example of Internal Policy Environmental Checklist

COMMERCIAL LENDING POLICY

9. Ask if the customer has any self-imposed emergency planning or control programs in place such as worker training to cope with emergency situations? _____

10. Ask if the customer carries any liability insurance to cover environmental risks of the customer's activities? _____

11. Will the customer provide the bank with a borrower indemnification statement protecting the bank against any environmental hazard liability imposed against the borrower as a result of the borrower's actions? (May not be obtainable in some cases due to prohibitions in certain federal and state laws.) _____

12. Will the customer sign a written warranty that as of the loan closing date, no violations of environmental laws exist and covenant that it will notify the bank of any violations in the future and will correct same in a timely manner? _____

13. Will the customer consent to the bank requiring inclusion of a technical default covenant in the event the borrower becomes unable to rectify an environmental violation? _____

14. Any OSHA, DOE, EPA citations (local/State Health)

Costs

Costs are understandably varied, and can range from \$400 for a simple Phase I assessment to \$6,000 for a more detailed Phase II. As previously stated, borrowers are generally responsible for paying for the assessment as well as any cleanup that might be required.

Competition in all industries are affected by the increasing costs in doing business. Environmental correctness is certainly one of these costs, and industry is feeling crunch as major U.S. corporations move overseas where labor is less expensive and legal ramifications are less daunting. Global competition in the banking industry is no different. Indeed, why should a company with access to foreign financing not take advantage of the less stringent standards available? It is not a case of foreign lenders not being aware of the environmental situation; the entire world seems to be aware of the problems. The difference is that international governments have not yet overcome some obstacles that would allow them to enforce their own environmental requirements. State interests conflict, for example, and there is the question of the assignment of liability in instances of interstate pollution (Int'l Envir. Law abstract). Until the international arena agrees on an aggregate policy, this small but real area of competition does exist.

CHAPTER IV
LENDER LIABILITY AND RESPONSIBILITY CREATED
BY ENVIRONMENTAL LEGISLATION
Areas of Major Risk

Stored Hazardous Chemicals

Stored Hazardous Chemicals are generally stored in drums, and if still on site should not be difficult to identify. Even if drums are not seen though, there is still the possibility of previous storage that may have resulted in spills or leaks. Discolored ground, inconsistent vegetation or dead patches may be indicators of past improper storage. A site free of any of these indicators may still be contaminated; this lack of positive identification is one of the larger risks of this type of hazardous waste (Singh).

Buried Waste

Buried waste may be one of the most threatening forms of hazardous waste, simply due to its widespread and largely undetectable nature (Singh). In past years, chemicals and drums have been dumped or buried in landfills or ditches. While this causes present day environmentalists to cringe, these methods were for years considered an acceptable and thus widely used form of disposal. The problems presented by this history are numerous: uncontained liquid or heavy

metals may have traveled with water molecules through the soil, affecting sites quite removed from the source site; the presence of these substances are often unknown and detection is difficult; and special instruments are often required to identify the presence of heavy metals.

Underground Storage Tanks

Underground storage tanks (USTs) in and of themselves are not a problem, except that leakage is difficult to detect and corrections expensive to make. Regulations for leak detection, corrosion protection and spill and overflow prevention for existing USTs became effective beginning in December, 1991. Leaking underground storage tanks (LUSTs) have become enough of a liability that some companies have elected to replace their UST systems with aboveground storage tanks (ASTs) rather than continually testing and repairing USTs. The trend toward AST usage is recent, and LUSTs will continue to present problems and expenses for many years to come. New USTs are being built with double walls and double contained piping, with monitoring wells and instruments to measure liquids and vapors between tanks (Gager 73). Regulations for ASTs are not yet in place. This is one of the disadvantages that companies who choose to install these are facing; regulations may require significant upgrades to the systems they've recently installed. Future trends will depend upon developing regulation, cost effectiveness and industry specific objectives. One issue that currently makes LUSTs particularly troublesome is the lack of pollution liability insurance. As developments and regulation progress, this issue may be resolved.

Asbestos

As might be suggested by the existence of its own legislation, asbestos is one of the most important hazards, simply due to the nature of its presence in so many older building materials, from plaster to insulation pipe wrap to floor and ceiling tiles. One advantage with asbestos is that it is relatively easy to find. Any commercial building constructed or remodeled prior to 1982 and residential improvements built or remodeled prior to 1962 are suspect. Asbestos removal, or abatement, is straight forward and well regulated. However, it may also be expensive, with possible costs in the millions of dollars for a single commercial building (Singh). Asbestos which is left undisturbed is generally not thought to be a hazard, but remodeling or disturbance of any kind poses a threat and will necessitate abatement. Abatement will also be required upon sale of property, especially with regard to commercial property, if not by the buyer, then by the institution which is financing the purchase.

PCBs in Electrical Transformers

PCBs are a type of chlorinated hydrocarbon commonly used as fire retardant insulating fluids in electrical transformers, capacitors and related equipment (Singh). PCBs are also found in fluorescent lighting equipment. Spills or leaks from PCB equipment or a PCB related fire may cause extensive contamination. This contamination can be very difficult and costly to remediate, and as such presents high risk (Singh).

Due Diligence Responsibilities

The one thing financial institutions regulatory agencies are clear about is that banks must follow due diligence proceedings in lending practices. This is especially important in mitigating the risk involving environmental issues. It is, in fact, a principal risk management tool.

Generally understood to mean a thorough investigation into the asset in question, due diligence is applied to any asset acquisition a bank undertakes. It applies equally to the extension of credit and the acquisition of an entire bank. This investigation, properly commandeered, will lay open the value of the asset as well as any risk involved. Appropriately, then, due diligence has the potential to uncover the likelihood of hazardous substance contamination and potential liabilities associated with the conducting of the business or owning of the property, thereby aiding in the estimation of value for the purchaser and level of risk for the lender. Some level of environmental due diligence investigation is recommended for any real estate transaction, business transactions involving real estate or possible acquisition of a business which might involve environmental liabilities.

Obviously, a bank does not lend money with the intention of ever owning or liquidating a business or owning a piece of real estate. The last five years in the Midwest and the present real estate glut in the northeast are proof enough that it does happen, and sometimes in mass quantity. The issue is, in fact, as broad as it seems; the solutions are more general and nebulous than perhaps one would like to see. Nevertheless, there are steps that can be taken.

The practical purposes for conducting environmental due diligence are several. The Innocent Landowner defense discussed in Chapter II requires documentation of "reasonable inquiries...before acquisition" and responsible reaction if contamination is found. The due diligence process should meet those requirements. In order to evaluate the potential costs associated with management of a particular risk, one must first know the nature and extent of the risk. Additionally, the due diligence process can help in the identification of potential for future problems as a result of property contamination, past hazardous substances practices of the business, potential costs involved in meeting compliance standards and the probable impact of regulations on the continued operation of a facility. This information should be integrated into the process of assessing whether to pursue the proposal and, if so, what conditions and terms are appropriate for the level of risk as regards pricing, documentation and so forth.

Environmental Site Assessment

Standards and Timing For the purposes of simplification of terms, taken from The Environmental Due Diligence Handbook, will be used. The term "environmental compliance audit" or "audit" describes the "systematic process of thoroughly evaluating an ongoing industrial operation to determine whether the operation complies with regulatory requirements regarding environmental issues." (Denton et al. 88). These have historically been used by the organizations themselves for planning purposes. "Environmental site assessment" or "assessment" will describe "those due diligence related reviews or assessments of property used for the purpose of evaluating potential liabilities associated with an

ownership interest in the property for integration into the decision process" of value and risk (Denton et al. 88). An environmental assessment will normally include a compliance audit. One or both of these searches should be undertaken prior to commitment of funds, if at all possible, and certainly prior to closing.

There has, in the past, been no standard for a typical or de minimus environmental site assessment. Today, more engineering firms are specializing in the assessment, but standards are still ambiguous and financial institutions would do well to determine their own minimum standards and then authorize several specific firms, whose work is of proven quality, to do the work.

Phase I and Phase II Requirements The Phase I audit is a preliminary or initial assessment, utilizing available information such as public records, site visits, management interviews, a check on prior uses, interviews with former site owners, and so forth. The assessment may stop at the Phase I if there is positively no indication of past or present misuse. The lender should look past a conclusion that assures a "clean" site and note any abnormalities found in the body of the report. Assessments have been known to report a clean property even though asbestos was found in floor tiles, for example.

The Handbook of Environmental Due Diligence suggests the following basis for a Phase I (Denton et al. 90,91).

- did operations produce wastes regulated under RCRA or state hazardous waste statutes?
- were or are USTs located on the property?
- have any federal or state regulated processes been performed on the property?
- was the property ever used for industrial purposes and if so, what industries?
- are there indications that the property has been used for waste disposal?

- have the subject or adjacent properties ever been used for the management of hazardous waste?
- have the subject or adjacent properties ever been used for manufacturing, processing or storage of potentially hazardous substances?
- have the owners or operators of the subject or adjacent properties ever been the subject of an environmental lawsuit?
- have the owners or operators of the subject or adjacent properties ever been the subject of an environmental compliance enforcement action by federal or state agencies?
- have asbestos containing materials been used in construction activities on the property?
- has there ever been an asbestos removal project on the property?
- are PCBs now located or has PCB equipment ever been used on the property?

A site inspection might involve a review of site records, interviews with employees and/or management, a visual inspection with an eye toward suspect signs such as those described earlier in this chapter, and a visual inspection of neighboring properties (Denton et al. 92).

The summary of the inspection should combine the information attained and present it in a way that clearly states the potential risk associated with the property. The information should include prior as well as current ownership and uses in enough detail to allow for a reasonable assessment of risk and help determine the need for further investigation (Denton et al. 93).

A Phase II audit is generally only required when the Phase I turns up suspicious results. If the earlier audit shows any indication of contamination, it is the aim of the Phase II to determine the extent and seriousness of that particular problem. Typically, the Phase II includes such items as site description, local land use analysis, site utilization analysis, soil borings, soil characteristic testing, tile sampling, laboratory analysis and recommendations for further action.

The Phase III assessment is really a misnomer. It is targeted at cleanup rather than assessment and, clearly, will vary depending upon the nature of the problem.

Adverse results of an audit may trigger reporting requirements under CERCLA or community-right-to-know acts. There is currently no standard rule, and situations are further complicated when the release of information may violate trade secret or attorney client privileges (Denton et al. 96). Further legal penalties may be imposed on owners with regard to intentional contamination or previous knowledge of hazards. These repercussions have not, as yet, proved a threat to lenders and are therefore beyond the scope of this paper.

A last consideration to be noted is that although a bank needs to standardize its requirements for the environmental compliance audit or environmental assessment and determine which engineering firms are acceptable, it has been suggested that the bank take care not to be a party to the contract between the borrower and the engineer (Busch 64). Reasons are four fold: if the engineer damages the site, the bank with whom he contracted could become involved in the lawsuit; the borrower must retain the engineer in order to establish necessary precautions under the Innocent Landowner defense; a borrower who relies on the engineer's opinion regarding purchase of the property should not be relying indirectly on the bank or its interpretation of the audit; and if the engineer provides the audit results to the bank who then provides them to the borrower, the bank may be seen as advising the borrower and subsequent damage could result in a lawsuit.

Lender's Risk From Environmental Contamination

Beyond CERCLA

Obviously, real property represents the greatest apparent risk when the issue is environmental liability. Previous discussion has addressed what the risks are most likely to involve with regard to types of contamination, how to discover whether or not these risks are present, and what steps to take if they are. Future discussion will address more subversive risks and methods lenders can use to protect themselves and mitigate liability. This chapter seeks to expand the list of possible risks when the property in question is not a direct threat.

One of the more apparent possibilities is the financial repercussions on the borrower if the land he owns becomes subject to federal or state mandated cleanup action. With cleanup costs possibly running into the millions of dollars, a company that is small, marginally profitable or over leveraged could find itself without sufficient cash flow or capital to handle its cleanup responsibility while continuing operations and servicing debt. It is also possible that the nature of the cleanup might require temporarily ceasing operations; companies without an unusually strong capital base cannot afford this inactivity for very long. Even if the borrower's properties are not held as security on his loan, the lender may find some comfort in having some knowledge of the environmental background and current condition of the properties owned or operated by its borrower (O'Brien and Frank A34).

An additional issue to ponder is that even if a borrower can qualify as an Innocent Landowner and escape the entire responsibility for cleanup, the property itself may become worth substantially less upon the discovery of contamination (O'Brien and Frank A25,A27). The value of equipment or inventory may also be affected by contamination, whether because regulation prohibits its use or because past contamination precludes future use (O'Brien and Frank A38).

Liability under the terms of a lease is vague. Under CERCLA, both lessor and lessee may be treated as owner or operator of the property (O'Brien and Frank A32). So, a lender financing a company who merely leases its facility should still satisfy itself as to the environmental soundness of the company's operations. Likewise, a lender who does business with a property owner whose business is only "landlording" should at least know the nature of the operations taking place on the properties. It may even be helpful to question the borrower about his methods of leasing. For example, a lender would have a higher comfort level with a property owner who had an awareness of environmental hazards and screened lessees accordingly than it would with one that was concerned only with short term cash flow. These issues flow down the ownership/operatorship path, creating joint and several liability for lessor, lessee, sub-lessee, etc. (Kimball 18). Lessors and lessees both have the right to request a restriction on operations, enduring only permissible activities. A lessee may also include in his contract the right to terminate his lease if any hazardous substances are found, but as the operator at the time of discovery or the most recent operator of an abandoned property, he may still be liable for damages under CERCLA (O'Brien and Frank A33).

Any corporation which has undergone a consolidation or merger as the surviving corporation is implicitly responsible for any liabilities assumed as a result. This includes not only real property issues, but also responsibility for improper disposal and so forth (O'Brien and Frank A34).

In five states as of Spring 1991, state legislation had the power to impose "superliens", or prior claims on properties for the cost of cleanup (Busch 52). These liens take priority over existing or future interests in the property, including perfected security interests (Kimball 14). There exists non-priority lien legislation in 17 more states, which allows the government to file a lien but it is subject to any prior liens.

Alternatives to Foreclosure

Banks are not in the business of owning property, and federal and state banking laws impose restrictions on this type of asset in a bank's portfolio. In addition to reporting requirements, a bank's Other Real Estate Owned (OREO) requires maintenance, annual appraisals, proof of ongoing disposal attempts, responsibilities of landlord and many other tasks that bankers would prefer to avoid. The environmental responsibility, though possibly one of the more potentially expensive consequences, is certainly not the only reason to avoid foreclosure. Matthew Kimball, a mortgage attorney, suggests some alternatives, which follow in brief (21,22).

A workout is almost always attempted before foreclosure is considered. In these cases, the lender must be very cautious of the "owner/operator" label. An environmental assessment of property and

operations should precede renegotiation, with the lender's decision to be involved with the workout operations of the company based on the probability of threat.

The bank might consider foreclosing on other assets held as collateral, or foreclosing on part of the real property. In this way, the lender may be able to avoid exposure to the part of the property which is contaminated.

If the loan has the support of strong guarantors, the lender might consider pursuing the guaranties rather than depending on the collateral.

If the potential liabilities associated with the collateral outweigh the value of the property, the lender might protect itself by giving up the lien and not bidding at the foreclosure sale.

The lender may be able to delay foreclosure, in the meanwhile reporting the environmental contamination to the proper agency. If the agency then forces the borrower to cleanup the site, the lender could foreclose after the work is done. If the agency itself cleans up the site, though, the lender should beware the possible repercussions of foreclosing before the agency has been reimbursed its expenses.

If the lender knows of environmental noncompliance occurring, he can seek an injunction to require the borrower to stop the activity in question. This serves to force the borrower into compliance and theoretically stops further damage.

The lender may have the option to appoint a receiver in the event of default. The benefit is that the receiver is an agent of the court and not of the lender. Therefore, if the lender is careful not to exercise direct control over the receiver, it may escape the

"owner/operator" problem. Of course, there are a whole set of possible liabilities for the receiver, so the practicality of this method is unproven.

A borrower forced into bankruptcy has the decisions regarding his assets relegated to the courts. This may shield the lender from the liability, but it will also probably delay repayment. Another problem with this idea is that there have not been any liaison laws between the bankruptcy law and the environmental law.

Issues in Foreclosing on Fouled Property

In cases where the alternatives are unacceptable or have been exhausted, foreclosure is often unavoidable. In such cases, Kimball has presented some issues of which lenders should be aware.

Due diligence should be performed, even if an audit was performed prior to extending credit. The Innocent Landowner defense requires "appropriate inquiries..." at the time of acquisition (22-23).

Caution should be observed with regard to the lender's activities before and during foreclosure. Any action that may be regarded as management influence is a threat to the lender's "owner/operator" defense. Additionally, as with Fleet Factors, any damage occurring during foreclosure proceedings increases the lender's probability of being held liable (23).

There may be some protection afforded a lender who has a subsidiary to bid at the foreclosure auction or take title to the property (23). While the parent has not been held liable as an "owner/operator" under CERCLA definition, there have been arguments made that the parent is the owner or operator indirectly through the

subsidiary when extreme control is exercised. The difference is a fine line, to be sure, and this is not a substantial stand alone defense.

A final thought from Kimball is the provision made under the secured creditor exemption verbiage whereby a bank must not hold the property for any cause other than to protect a security interest. This implies that a lender must take immediate steps to dispose of the property.

Loan Structure and Documentation

Issues and Alternatives in Taking a Mortgage

The high cost of environmental contamination and the resultant liability overshadow the entire loan process, from preliminary research to the cost of the credit and choice of collateral. As previously stated, a borrower in an environmentally active business or situated on a contaminated piece of property poses a threat to the interests of even those creditors who do not hold mortgages. The cost of a cleanup could reduce or eliminate the borrower's ability to pay his obligations. In these cases, thorough site assessment and background checks, together with ongoing covenants and assurances of compliance with environmental standards, are perhaps the lender's best defense.

It is a fact, though, that many loans would not be made on an unsecured basis. While there are alternatives to taking a mortgage such as taking an interest in accounts receivable, inventory, equipment or other asset, or obtaining personal guaranties by strong principals, these measures are not always appropriate or sufficient. A guarantor is only valuable if he's worth something, and he may also be hurt by a liability suit. Taking current assets such as accounts receivable and

inventory as collateral on a loan with a long term purpose such as the purchase of real estate, construction of an improvement or acquisition of a company is generally not considered appropriate loan structure. Terms and collateral should be designed to correspond with the loan purpose. Alternatively, in a situation where an acquisition is being funded, security in corporate stock or equipment may not be enough to give the lender comfortable collateral coverage. The truth of the matter is that taking a mortgage is the only viable option if the loan is to be made. Banks cannot afford to turn away all business with the hint of an environmental problem. The best course of action then, is for lending personnel to establish policy, protocol and procedure, and then take all precautions necessary to reduce risk exposure.

Attaining a Balance Between Risk and Caution

This paper has already expounded on the necessity and value of an environmental compliance audit, or at the very least, a clean site assessment. Certain other risk clarifying information can be gleaned from processes used as a matter of course in any loan investigation.

The lender should know what the prospective borrower's business is: what it does, how it does it and what level of quality it pursues. A related issue is the borrower's historical level of awareness, cooperation and compliance with regard to any legislative issue, be it income tax or pollution control.

Investigation of the collateral is always imperative, whether environmental threats exist or not. Issues such as prior ownership and use should be addressed, though these are implicit in a Phase I audit. The lender should take steps to know the legislation of the state where

the property is located, with regard to the imposition of liens or superliens for example, in the case of a mandated cleanup action (Kimball 19).

Property and title insurance are standard practice in today's real estate lending arena. Documentation is generally fairly stringent with regard to these coverages. The area of environmental insurance coverage, though not new, has not been highly utilized in the banking industry in the past. Though coverage has been available for some time, recent events have caused several major insurance companies to both raise premiums and limit coverage (Kimball 18). A ruling of the California Supreme Court in the case of AIU Insurance Company vs. Superior Court in 1990 stated that cleanup costs incurred under Superfund and state legislation are covered under comprehensive general liability policies unless specifically excluded (Kirschenbaum 47). Similar decisions have been handed down in several other states, although a number of decisions denying coverage have also been awarded (Adler 3). The emerging solution appears to be a niche marketing system which is replacing broad based coverages (Kertesz 3). In this system, insurers focus on one specific market (e.g. hospitals) and/or on specific hazards (e.g. USTs). This may well be the way of the future in dealing with environmental uncertainties in a practical, cost effective manner. As the risks and payoffs become more well-defined and costs stabilize, the environmental insurance requirement may find its way onto documentation checklists in commercial banks across the country.

Representations, Warranties, Covenants and Indemnification Provision

In spite of the large quantities of verbal information exchange, the key word in today's banking environment is documentation. This begins with the loan agreement and/or commitment letter. It is in these documents that specific obligations and requirements are imposed upon the borrower. Typically, these include frequency of financial statement submittal, minimum standards of operations as depicted by carefully chosen ratio limitations, principal extension, payment and interest rate commitments, specification of collateral, guaranties, lender rights, borrower's rights, and so forth.

Some additional items that should be included in light of environmental issues are environmental audit requirements, environmental insurance requirements, lender access to records having a bearing on hazardous waste generation and disposal, commitment to continue regulatory compliance and similar representations which the lender might find feasible (Kimball 19,20).

Kimball warns that no provision will absolve the lender if it is found to be an "owner" or "operator" under CERCLA. He does suggest some ideas of warranties and representations that may be helpful in limiting risk and maximizing information provisions, however (20,21). Some suggestions are:

- compliance of all past and current uses of the property with federal, state and local environment laws and regulations;
- borrower knows of no releases or threatened releases of hazardous materials on the real estate or any contiguous property;

- all notices of violations of environmental statutes, orders or provisions have been disclosed to the lender;
- all knowledge of pending or threatened government action has been disclosed, and any future notice will be reported to the lender immediately;
- lender will be provided immediately with notice of any release of hazardous substances on the property;
- borrower covenants as to the kinds of activities in which it will engage on the premises;
- guarantee cooperation with government authorities and complete any appropriate testing, investigation and remediation in connection with waste release;
- generation and disposal of hazardous waste will be done in accordance with all federal, state and local regulations;
- lender should be indemnified against loss, liability, damage and expense incurred as a result of breach of covenants by the borrower (may include personal guaranties);
- lender should be given the right to inspect the business operations and premises periodically;
- lender should be granted the right to undertake such action as necessary to address environmental issues, and to capitalize any expense as additional indebtedness of the borrower.

All of these rights should be exercised with caution, most notably the last. And, as Kimball notes, lenders should not include in their documents any provisions which would grant a lender the power to direct or control its borrower's handling of hazardous waste and remediation activities.

CHAPTER V

SUMMARY: THE FUTURE OF ENVIRONMENTAL LIABILITY IN THE BANKING INDUSTRY

This paper has attempted to clarify the most basic issues involved with environmental liability as it relates to practical lending standards. It is clear that the issues are very broad; nearly every chapter has the capacity to be an entire paper in itself. As the laws are further specialized, the current maze of "what ifs" will undoubtedly become more convoluted.

As with all things which have gone before, however, lenders will rise to the challenge and adapt to the new risks. The public and private sectors will likely take on more responsibility, and as the old problems are solved perhaps new ones will arise with diminishing frequency.

At this closing, the EPA proposal issue has still not been resolved. Many important areas remain ambiguous and gray, but two points do seem to stand out: due diligence is of key importance in any kind of defense; and the holding of a property to protect a security interest must be proven, especially if the lender must continue operations to maintain the value of the collateral.

As lenders build their defenses, environmental regulatory bodies are attempting to find new ways to place blame. One area which is so

new that the cases involving it have not been settled is the question of contributory negligence. At the outset, this topic was one which the writer intended to cover, as it bears distinct ramifications. However, research proved to yield a scarcity of information on the topic. This is presumably due to the recency with which the issue has come into the legal view. Cases in New Jersey and Maryland are currently underway whereby the prosecution claims that the lender, by financing the waste generator's business, is guilty of the same damage as is the generator. This tactic seems to be a point of last resort for lenders who have chosen to write off the loan rather than claim the collateral. Whether this method of attack will succeed remains to be seen. In the meanwhile, environmental liability for the lender is a game of building castles, walls and moats, then protecting the kingdom to the best of his ability.

SUBSEQUENT NOTE: On April 27, 1992 the Bureau of National Affairs reported on the final ruling released by the EPA to clarify circumstances under which environmental liability exemptions apply. Per EPA Deputy Administrator F. Henry Habicht, as quoted in the article, "The rule makes it clear that lenders engaging in 'traditional activities - advancement of a loan, inspection and other consultative activities with regard to policing, work-out activities, preforeclosure activities, and even activities after foreclosure - are not subject to superfund liability except under certain defined conditions.'" The rule also addresses participation in management and trustee exemption. A copy of the BNA article is attached.

Regardless of this new development, the writer contends that the meat of this paper remains relevant. The EPA rule does not prevent borrowers from encountering bankruptcy as a result of cleanup costs. Further, in the event of foreclosure on contaminated property, a ruling protecting the bank from liability is not likely to make the property any more attractive to a prospective buyer. In short, the banking industry would still be well served to exercise caution in the area of environmental responsibility.



LEADING THE NEWS

47a

Superfund

FINAL LENDER LIABILITY RULE RELEASED; EPA SAYS IT CLOSES COMPLIANCE LOOPHOLE

President Bush April 24 announced release of the Environmental Protection Agency's final rule to clarify circumstances under which lenders and certain government institutions are exempt from liability under the federal superfund law.

The final rule clarifies what activities lenders may undertake while remaining within superfund's "security interest" exemption. It also provides that government lenders, receivers, or conservators that involuntarily acquire contaminated property are eligible for superfund's "innocent landowner" defense from liability.

The rule makes clear that lenders engaging in "traditional activities — advancement of a loan, inspection and other consultative activities with regard to policing, work-out activities, preforeclosure activities, and even activities after foreclosure — are not subject to superfund liability except under certain defined conditions." — EPA Deputy Administrator F. Henry Habicht

The rule was released at a White House briefing along with other financial reforms as part of President Bush's 90-day regulatory review initiative. The president — who brought together senior officials from the White House, the Federal Reserve, EPA, and the Treasury Department to help him explain the initiatives — will extend the 90-day moratorium April 29, citing its achievements in reducing costly burdens on the economy (80 DEN A-16, 4/24/92).

At an EPA briefing, EPA General Counsel Raymond Ludwiczewski stressed that the final rule retains the same structure and intent as the June 5, 1991, proposed rule. But Ludwiczewski said that the final rule corrects an "inadvertent error on EPA's part" that left a loophole in the agency's test for what constitutes participation in management under the superfund law's security interest exemption. The final rule clarifies that lenders may not "carve out" environmental compliance activities as the only "management" activity that would void their exemption from liability, agency officials said.

Speaking to reporters at the White House, Deputy Treasury Secretary John Robson commended EPA's efforts. Robson said the rule will clarify lenders' environmental liability and "make it easier for banks and other lenders to see quite clearly the lines over which they can't cross before they risk being liable for environmental exposures."

The rule, Robson said, "will create a great deal of confidence in the lending community." In addition, he said, the rule will help the Resolution Trust Corp. and the Federal Deposit Insurance Corp. in their role as the inheritor of bank assets that come in from failed banks and thrifts. "It also will clarify the exposure of agencies, like Customs, that seized properties in the course of their law enforcement activities, and the Internal Revenue Service, which also takes over a variety of properties," he said.

EPA Deputy Administrator F. Henry Habicht told reporters at the White House that the rule makes clear that lenders engaging in "traditional activities — advancement of a loan, inspection and other consultative activities with regard to policing, work-out activities, preforeclosure activities, and even activities after foreclosure — are not subject to superfund liability except under certain defined conditions."

According to Habicht, the rule provides that unless a lender goes beyond "normal lending activities and actually becomes the manager and the operator of a site, engages in general operational management, or takes over environmental activity... that lender is not subject to the joint and several liability of the superfund law."

Participation In Management Revised

Under the Comprehensive Environmental Response, Compensation, and Liability Act, lenders qualify for the so-called security interest exemption from liability for contaminated property they hold as a security interest only if they do not "participate in the management" of the facility.

Although the exemption is spelled out in the statutory language, EPA said the extent to which a lender may become involved in a facility without also being considered to be participating in management is not defined by statute or in CERCLA's legislative history.

A series of court decisions caused concern and confusion in the banking industry by interpreting the provision without providing a clear definition for "participation in management." Most notably, the 11th Circuit Court of Appeals decision in *U.S. v. Fleet Factors Corp.* (901 F.2d 1550, 1990), suggested that a secured creditor could be liable if it participates in management "to a degree indicating capacity to influence the corporation's treatment of hazardous wastes."

EPA's final rule revises the agency's test for participation in management. The proposed rule had established a two-pronged test. It specified that lenders participated in management of a facility if the lender exercised decisionmaking control over the borrower's environmental compliance or if it exercised control "at a management level encompassing the borrower's environmental compliance responsibilities."

EPA revised the test based on concerns that the proposed test could allow lenders to artificially "carve out" a company's environmental compliance activities while otherwise fully operating a facility. A lender could claim that as long as it was not involved in environmental compliance activities, it would remain eligible for the exemption, the commenters argued. EPA said it did not intend to provide such a loophole.

The new test provides that a lender "participates in management when it assumes or manifests responsibility for the overall management of the enterprise encompassing the day-to-day decisionmaking over either (A) the enterprise's environmental compliance or (B) all, or substantially all, of the operational aspects of the enterprise other than environmental compliance."

The rule further clarifies that a lender's "involvement in financial or administrative matters does not rise to a level of management participation that will void the exemption..." Specifically, EPA said that security holders performing functions including "plant manager, operations manager, chief operating officer, chief executive officer, and the like" will be considered to be involved with operational aspects that constitute participation in management.

Financial or administrative functions that are not considered participation in management include functions such as "credit manager, accounts payable or receivable manager, personnel manager, controller, chief financial officer, and similar functions."

Exemption Not Extended To Trustees

The final rule also addressed comments by many lending institutions urging the agency to extend the security interest exemption to cover trustees and fiduciaries.

EPA said the rule does not address trustees because neither the security interest exemption nor any other section of CERCLA makes any special provision for trustees.

But, EPA said, "the assumption of several commenters — that "a trustee is *personally* liable under CERCLA solely because a trust asset is contaminated, even if the trustee had no knowledge of the asset's contamination and was in no way involved in the activities that resulted in the contamination — is incorrect. A trustee is not personally liable for CERCLA cleanup costs solely because a trust asset is contaminated by hazardous substances."

But Habicht told reporters that EPA "will continue to examine [CERCLA's] unintended consequences with regard to trustees and lenders in other areas of waste management, as well."

Other waste management areas include the Resource Conservation and Recovery Act, which contains a similar security interest exemption for owners of underground storage tanks. EPA said some commenters formally petitioned the agency to promulgate a rule that would define the RCRA security interest exemption in the same manner as the CERCLA exemption. In response to those petitions, EPA said, it has begun work on such a rule.

EPA enforcement attorney John Fogarty, who coordinated release of the rule, said other modifications in the final rule were mostly technical in nature.

Other agency officials stressed that the final rule made explicit that lenders who seek to cleanup contaminated properties will not be held liable under superfund. At the same time, they said, lenders that cause an environmental release at a facility, either before or after foreclosure activity, can be held liable.

The 178-page rule was signed by EPA Administrator William K. Reilly late April 23, according to agency officials. It includes a detailed, 167-page preamble summarizing public comments and providing justifications for the agency's rulemaking.

Ludwiszewski said the rule will be published in the *Federal Register* within the next few days, and it will be effective upon publication.

Text of the rule is in a Special Supplement to this report. □

End of Section

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