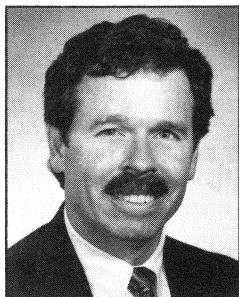


FEATURE ARTICLE

**THE NEW LENDER RULE AND
ENVIRONMENTAL LIABILITY BASED ON FAULT:
SECURITY FOR LENDERS AND BUYERS**

By Cameron Kirk, Jr.



CERCLA's drafters intended to impose liability for remediation costs on those parties who "caused or contributed to a release or threatened release of hazardous wastes." See H.R.Rep. No. 1016, 96th Cong. 2d Sess. 33 (1980) reprinted in 1980 USCCN 6119, 6136. Nevertheless, since

CERCLA's inception faultless landowners and financial lenders have suffered real or threatened exposure to liability for remediation costs. The risk of incurring liability in these drastic and costly regards has caused many properties to be subject to contamination blight; a chill on buying and lending practices causes the sale of contaminated properties to be extremely difficult, while many businesses are unable to finance the purchase of real property having any taint of contamination.

Regulations, however, emphasize CERCLA liability based on fault. This spells good news for present and potential landowners, lenders and businesses. Informed and prudent real property owners, buyers and lenders may now transact the sale and purchase of real property, even contaminated property, with more security.

This article discusses what the author views as an evolving trend toward placing liability for the cost of CERCLA contamination cleanup on those parties actually responsible for the contamination. The most

evident facet of this trend consists of the new federal regulations regarding lender liability under CERCLA. Following a discussion of past law on lender liability and the new lender liability regulations, the impact of these regulations on today's real estate transactions will be discussed. In conclusion, practical tips will be suggested regarding how real property may be bought, sold and financed to afford maximum protection, and increased comfort, to interested parties.

U.S. v. Fleet Factors Corp./Lender Liability

CERCLA is a remedial statute establishing procedures whereby hazardous waste sites and releases of hazardous substances may be cleaned up. Potential Responsible Parties (PRPs) are subject to strict liability for the cost of such clean up. PRPs include past and present owners or operators of facilities where hazardous waste is discharged into the environment so as to cause a public danger.

Since its inception CERCLA has exempted from its definition of owner/operator any person who, without participating in the management of a facility, holds indicia of ownership primarily to protect a security interest in the facility. 42 U.S.C. § 9601 (20)(A).

Several cases have interpreted this exemption, focusing on the phrase, "without participating in the management of a facility." The government has argued consistently that the phrase should be read strictly, literally and narrowly, holding that any lender participating in any way in the management of

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a PRP loses its exemption. The financial industry, of course, has argued that secured lenders have a direct interest in the management of their security. A ruling which prohibits secured lender involvement in the affairs of the borrower would vitiate the exemption.

The 11th Circuit Court's well known and controversial decision, *U.S. v. Fleet Factors Corp.*, 901 F.2d 1550 (1990), *reh'g denied*, 911 F.2d 742 (11th Cir., 1990) (en banc), *cert. denied*, 111 S.Ct. 752 (1991), considered these countering views, and held that a secured lender who may have been able to control management decisions is not exempt from CERCLA liability. This ruling is particularly interesting because the court initiated its discussion of CERCLA liability by noting:

The essential policy underlying CERCLA is to place the ultimate responsibility for cleaning up hazardous waste on "those responsible for problems caused by the disposal of chemical poison." [citations omitted.] (At p. 1553.)

The decision, however, relied ultimately on what the court viewed as the "overwhelming remedial" goal of CERCLA and the conclusion that ambiguous statutory terms should be construed to favor liability for remediation costs incurred by the government. In so construing the statute, the circuit court lost sight of CERCLA's real purpose of imposing liability on those causing the release of contaminants into the environment.

The *Fleet Factor* ruling has been the subject of much debate, and has caused great consternation and frustration within the real estate and lending industries. Most importantly, the decision has caused lenders to be extremely hesitant to finance the purchase of real property having any possibility of being contaminated. Unfortunately, in most metropolitan areas the number of properties so tainted is significant. Thus, a great deal of real estate is subject to "contamination blight."

Similarly, prospective purchasers are hesitant to purchase properties which may be contaminated. As any industrial area is nearly certain to have some contamination, whether particular to individual pieces of property or spread area-wide by groundwater, storm runoff or other means, real property in such areas is extremely difficult to sell or finance for sale. This "contamination blight" contributes to economic hardships throughout California.

Lender Liability Defined by Lender Rule

After lobbying by the financial and real estate industries, a federal regulation was enacted on April 29, 1992: 57 Fed. Reg. 18344 (codified at 40 C.F.R. § 300.1100 - 1105). This regulation, referred to herein as the Lender Rule, addresses the very issues decided by the *Fleet Factor* court and establishes guidelines to be used in interpreting the secured lender exemption. The Lender Rule, however, returns to CERCLA's original purposes, stating generally that a secured lender is subject to the statutory exemption, and thus not liable, unless the lender actually participates in the running of the business while it disposes of, discharges or transports contaminants. A brief summary of the Lender Rule is as follows.

Actual Participation in Management

Under the Lender Rule actual participation is necessary to defeat the exemption, not the mere capacity to influence a facility's operations. This requires a factual and objective analysis of the extent to which a lender is involved with its borrower's operations. So long as the borrower is still in possession of the facility encumbered by the security interest, the lender is deemed to be participating in management only if it either, (1) undertakes decision-making control over the borrower's environmental compliance or (2) exercises control over the borrower such that the lender has assumed responsibility for the overall management of the borrower's day-to-day business regarding environmental compliance or substantially all of the borrower's business. The Lender Rule specifically compares the lender's overall management to lender involvement with only financial or administrative matters. Such limited involvement does not defeat the exemption under the Lender Rule.

Actions at Inception of Loan

A prospective lender remains exempt from PRP liability if it requires or undertakes environmental investigation or requires environmental remediation work to be performed at the subject property. Moreover, a lender need not conduct an environmental inspection of the property, and lender liability cannot be based on whether or not the lender conducted or required any environmental inspection.

Policing and Workout

Without losing the exemption, lenders may take such action regarding the borrower and the subject property as is consistent with holding ownership indicia primarily to protect a security interest. Lender action may be taken prior to foreclosure and may include, among other things, (1) requiring the borrower to clean up the facility or take action necessary to come into compliance with applicable environmental and other laws, rules and regulations; (2) exercising authority to monitor or inspect the facility; (3) restructuring or renegotiating the terms of the security interest; (4) requiring payment of additional rent or interest; (5) exercising forbearance; (6) exercising any right consistent with the lender is entitled to by law or under contract with borrower; or (7) providing specific or general advice relating to finances or other business matters.

CERCLA Action

The lender does not void the exemption by taking any response action pursuant to CERCLA directives or under the direction of an on-scene coordinator.

Foreclosure

Even upon the lender taking the property in foreclosure the exemption remains valid, so long as (1) the indicia of ownership is maintained primarily to protect a security interest, and (2) the lender attempts to sell, re-lease or otherwise divest itself of control of the property reasonably expeditiously. This divestiture may be undertaken using whatever commercial means are reasonable or appropriate to the situation, "taking all facts and circumstances into consideration, and provided that the [lender] did not participate in management. . . prior to foreclosure." 40 CFR 300.1100(d)(1).

In order to ensure the lender's primary purpose of protecting its security interest the Lender Rule requires certain time limits within which the lender must seek to divest itself of the property. Within 12 months from the date of foreclosure the property must be suitably advertised for sale or other disposition at fair consideration. The lender must respond to any offer of fair consideration within 90 days. Further, the lender is not allowed to outbid, reject or fail to consider an offer of fair consideration for the property. Any act by the lender contrary to these require-

ments is deemed inconsistent with the lender's primary security interest, and so voids the lender's exempt status.

CERCLA Liability Independent of Status as Owner

Finally, if the lender forecloses on a property pursuant to the requirements of the Lender Rule, the lender's liability is specifically determined independently of its status as owner or operator of the property or business. The lender/owner incurs CERCLA liability only if it arranges for disposal of hazardous substances or agrees to transport and dispose of the same. The lender does not incur liability by taking any action pursuant to CERCLA or at the direction of an on-scene coordinator.

Lender Rule Analysis

The foregoing discussion highlights some of the Lender Rule's more important points and demonstrates its reliance on factual analyses. Each of the Lender Rule requirements looks to factual and objective actions taken by a lender in support of, or contrary to, its primary security interest. If the lender does not act contrary to such requirements, its exemption from CERCLA liability remains intact. This fact analysis determines the lender's potential liability for CERCLA remediation costs.

Thus, the Lender Rule demonstrates an important shift in the evolution of environmental regulations and enforcement. Not only does it act as a guideline for lender liability, but it also demonstrates a change in emphasis by governmental enforcement agencies. The *Fleet Factor* court noted superficially CERCLA's primary purpose of imposing liability for clean up costs on those parties responsible for the discharge of hazardous substances. Then, however, the court based its decision on factors unrelated to factual fault. The Lender Rule, as adopted by the EPA, provides precedent to the contrary. Lender liability under CERCLA no longer rests on mere indicia of ownership, but exists only upon an objective analysis of fault.

Lender Liability in California

It must be noted that CERCLA does not preempt the states' rights to adopt more stringent environmental controls and regulations. 42 U.S.C. § 9614.

Rather, CERCLA authorizes the president to enter into agreements with the state, designating state agencies as lead enforcement agencies for CERCLA. Thus, state agencies manage and implement CERCLA projects, with federal funding used to assist in state management.

Nevertheless, Health and Safety Code § 25187 provides statutory authority to hold persons liable for violations of CEQA, with language similar to CERCLA liability language, but without a security interest exemption. Therefore, it is possible that a lending institution holding California property as loan security may be subject to a State remediation action without reference to CERCLA and the Lender Rule. This, however, should not be a major concern. Miller & Starr in *California Real Estate 2d* state that the administrative practice within the state is not to name financial lenders in enforcement proceedings unless the lender actively participates in the management of the business such that the lender could be held to have "permitted" a discharge under the Act. Furthermore, Miller and Starr indicate that lender liability in California will be seen in light of CERCLA and its provisions. *California Real Estate 2d*, H.D. Miller and M.B. Starr, Vol. 9 § 29.80, fn 83, pp. 207,208 Thus, the Lender Rule should serve as precedent in purely state actions, as well as under CERCLA.

Lender Rule Impact on Real Property Transactions and Liability

Lender

The Lender Rule provides a great deal of new found security to financial institutions using real property as loan security. The detail provided by the rule allows a lender to structure real property transactions so as to achieve maximum protection of its security interest without risking exposure to CERCLA liability. Just as the Lender Rule considers the lender's activities from inception of the loan through foreclosure, so the lender may establish practices and procedures of its own to direct the entire course of a secured loan without incurring liability for clean up costs. Moreover, in any particular situation regarding a security interest, the lender is now well advised by the Lender Rule of what action

may be taken to protect its security without invalidating CERCLA's lender exemption.

Buyers

Present and past owners of contaminated property remain strictly liable for the cost of remediation. Nevertheless, CERCLA specifically allows private parties to allocate risk between themselves. 42 U.S.C. 9607(e)(1). Thus, with certain contractual protections a buyer of property can act effectively to restrict or limit his or her exposure to liability for remediation costs.

The Lender Rule, though addressing only CERCLA's lender exemption, provides insight into the assessment of a buyer's risk as well. Prior to EPA's adoption of the Lender Rule, and despite CERCLA's provision allowing for the allocation of risk, buyers were forced to recognize only their strict liability as PRP's. Just as the *Fleet Factor* court was driven by its view of CERCLA as a vehicle to recover remediation costs from any possible source, so a buyer with little or no factual responsibility for property contamination could expect no judicial relief from CERCLA liability.

The Lender Rule, however, demonstrates the EPA's recognition that CERCLA is intended to impose liability for cleanup costs on those persons responsible for the contamination. Thus, a buyer's attempt to allocate risk through contract should gain favor in regulatory and judicial actions. Similarly, the innocent purchaser defense should become more viable in today's remediation actions.

Practical Steps Taken by Lenders and Buyers Will Provide Additional Security

As the Lender Rule addresses the particular aspects of lenders' actions regarding security interests, so a lender may take very practical steps to reduce its exposure to CERCLA liability. Step-by-step guidelines may be adopted by financial institutions to stay within the boundaries of the lender exemption. Following such guidelines will significantly reduce a lender's risk in financing the purchase of contaminated real property.

Similarly, though without the guidelines provided for a lender, a buyer must attempt to address the potential contamination problems associated with a

particular property. The buyer must investigate the property and its history thoroughly. An environmental audit must be undertaken, including environmental testing and monitoring, along with detailed written questionnaires to all known previous owners. In short, as much information as possible must be gathered to assess the risk of contamination and where fault lies for such contamination.

With information in hand, the buyer must evaluate the risks and allocate them. This involves careful negotiating and drafting of purchase agreements. Though the preparation of such purchase agreements is beyond the scope of this article, it is important to recognize the importance of such agreements in light of CERCLA's expressed intentions. As factual responsibility is emphasized through the Lender Rule or otherwise, a buyer may seek considerable protection through the terms of contractual agreements.

The buyer must then take all precautions to ensure that hazardous substances are not discharged during his ownership of the property. An overabundance of caution in this regard will be well spent to minimize an owner's risk of liability.

Finally, a prudent buyer will become acquainted with regulatory agency personnel, providing them in writing all pertinent information regarding the subject property, potential or known contamination, and all steps taken currently to ensure safe and secure handling of hazardous substances. While the property owner or lender may be reluctant to initiate such a dialogue, it is the best way to address contamination which may have been caused by predecessors and their responsibility for same. This, in turn, more accurately defines the buyer's potential liability.

Conclusion

Any property conveyance relies on certainty and predictability. CERCLA liability based on factual fault, rather than the broad construction of ambiguous regulations and statutes will help provide greater certainty and predictability. The Lender Rule has greatly reduced the ambiguity previously found in CERCLA regarding lender liability. Based on the Lender Rule financial institutions may structure their loan practices to conform with the boundaries established for lender exemption from liability.

Similarly, buyers may take more comfort and security in EPA's emphasis on those persons actually responsible for the release of hazardous substances. Practical steps taken by buyers may significantly reduce potential exposure to clean up liability.

Finally, all interested parties should be pleased with the direction taken by the Lender Rule. No longer is the emphasis on finding any deep pocket to help finance the remediation of a contaminated property. Rather, enforcement agencies return to CERCLA's original purpose and seek to impose liability on those responsible for the contamination. So long as the laws, regulations, enforcement agencies and courts look to responsible parties for financing contamination remediation, all parties are best served.