TULANE ENVIRONMENTAL LAW JOURNAL

VOLUME 5 DECEMBER 1991 ISSUE 1

THE LENDER LIABILITY PARADOX: A FRESH APPROACH

ANTHONY R. CHASE*

INTRODUCTION

The liability of lenders under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA)[1] has generated much debate and publicity during the past several years. Lending institutions charged with the cleanup of their borrowers' contaminated property can be held liable for costs.[2] Frequently the costs exceed one million dollars and they can easily exceed one hundred million dollars.[3] This vulnerability to tremendous liability has lenders scrambling for guidance on reducing their exposure. Actually obtaining that guidance may be difficult. Some courts have expansively interpreted the liability provision of CERCLA, but little judicial guidance is provided to lenders who wish to establish policies or procedures that can protect them from liability.

The purpose of this article is to analyze lender liability under CERCLA, emphasizing the historical context of the development of lender liability under other theories and the

* Associate Professor of Law, University of Houston Law Center. A.B., Harvard College; J.D., Harvard Law School; M.B.A., Harvard Graduate School of Business Administration.

1. Pub. L. No. 96-510, 94 Stat. 2767 (codified as amended at 42 U.S.C. §§ 9601-9675 (1988)).

2. *See* Steve Bergsman, *Banks Swamped in Toxic Waste*, BANKERS MONTHLY, March 1989, at 27-31; Stacy Adler, *Courts Split Over Liability of Lenders for Site Cleanup*, BUS. INS., Sept. 3, 1990, at 2.

3. *See* I. Leo Montiuk & Daniel J. Sheridan, *New Jersey's ECRA: Problems, Policies, Future Trends*, 21 Env't Rep. (BNA) 549, 550 n.9 (July 27, 1990) (listing cleanup costs incurred at contaminated sites under New Jersey's CERCLA-equivalent regulation).

impact of CERCLA lender liability on the lending industry, and to determine whether more traditional theories of lender liability can provide guidance in the development of standards of conduct for lenders seeking protection from CERCLA's liability provisions. Section I of this article contains a survey of theories of lender liability developed outside of CERCLA liability considerations. Section II sets forth the relevant liability provisions of CERCLA, as well as the relevant legislative history and amendments enacted by the Superfund Amendments and Reauthorization Act of 1986 (SARA),[4] and contains an analysis of the impact on the lending community from the judicial interpretations of lender liability under CERCLA and the subsequent congressional response. Section III proposes that existing standards of conduct under traditional lender liability theories can be applied to provide guidance for interpreting CERCLA's liability provisions. The conclusion further proposes that Congress look to these principles in creating some guidance for lenders.

I. A SURVEY OF THEORIES OF LENDER LIABILITY

Although borrowers have been suing lenders for years,[5] the volume of lender liability litigation has increased dramatically during the past decade.[6] Well-publicized multimillion dollar verdicts against lenders[7] encourage borrowers to defend even the most routine collection actions by attacking their lenders.[8] Lender liability suits are most often brought after borrowers default on commercial loans. Borrowers allege many theories of liability against their lenders, including breach of contract,[9] breach of fiduciary duty,[10] breach of good faith,[11] fraud,[12]

4. Pub. L. No. 99-499, 100 Stat. 1613 (codified as amended in scattered sections of 26 U.S.C. and 42 U.S.C.).

5. *See generally* Peter H. Weil, *Liability of Lenders and Certain Other Parties in* TROUBLED LEVERAGED BUYOUTS, 207 (PLI Corp. Law & Practice Course Handbook Series No. 694, 1990).

6. Frances E. Freund, Special Project, *Lender Liability: A Survey of Common-Law Theories*, 42 VAND. L. REV. 855, 855 (1989).

7. Melissa Cassedy, Note, *The Doctrine of Lender Liability*, 40 U. FLA. L. REV. 165, 166 (1988).

8. Freund, *supra* note 6, at 855.

9. *See* Freund, *supra* note 6, at 857-61. Traditionally, lender liability suits were based on contract claims. Contract claims are not as popular among plaintiffs today because of the relatively limited damages available. Contractual damages are designed to provide the "benefit of the bargain," but are not designed to punish or to provide speculative or unforeseeable damages. As a result, plaintiffs hoping to recover more than the "benefit of the bargain" typically allege tort theories against their lenders.

10. *See infra* notes 20-36 and accompanying text.

duress,[13] interference,[14] and negligence.[15] Statutory bases for borrowers' claims include bankruptcy laws,[16] federal securities laws,[17] tax laws,[18] and the Racketeer Influenced and Corrupt Organizations Act (RICO).[19] Because awards to borrowers under common-law theories expose lenders to greater liability and because tort theories are based upon standards for lenders' conduct, this section will survey and analyze on the common-law bases for lender liability, grouped under the following headings: breach of fiduciary duty, equitable subordination, tortious lender liability, and breach of the duty of good faith.

A. *Breach of Fiduciary Duty*

Although tort and fiduciary liabilities are not new to lenders,[20] the frequency of their application has increased to the point where it is common practice to include at least one such claim in any suit against a lender.[21] Recovery under a tort or fiduciary duty theory requires the borrower to establish that the lender owed a duty of care to the borrower. Although a fiduciary duty can be established in several ways, two ways frequently used by borrowers are the "control" and "special relationship" theories.[22]

1. Control

Lenders frequently become involved in the management

---

11. *See infra* notes 70-82 and accompanying text.
12. *See infra* notes 58-60 and accompanying text.
13. *See infra* notes 61-63 and accompanying text.
14. *See infra* notes 64-65 and accompanying text.
15. *See infra* notes 66-69 and accompanying text.
16. A finding that a creditor controlled a debtor may result in the creditor being classified as an "insider" of the debtor under the Bankruptcy Code. 11 U.S.C. § 101(30)(b)(iii) (1988). If the creditor is classified as an insider, the preference period during which payments to the creditor can be challenged is extended from 90 days to one year. 11 U.S.C. § 547(b)(4). This insider status may also result in the equitable subordination of the creditor's claim. *See infra* notes 37-41 and accompanying text.
17. If a lender is found to be a controlling person, the lender may be liable under the Securities Act of 1933, 15 U.S.C. § 77o (1988), and the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) (1988).
18. A lender that provides a borrower with funds to be used for the borrower's payroll may be liable for failing to collect and remit withholding taxes. 26 U.S.C. § 3505(a) (1988).
19. A lender may be held liable for engaging in activities that are proscribed by RICO. 18 U.S.C. § 3505(a) (1988).
20. *See, e.g.*, Earl Park State Bank v. Lowmon, 161 N.E. 675 (Ind. App. 1928).
21. Freund, *supra* note 6, at 862.
22. *See generally id.* at 861-72.

and operation of a financially distressed borrower. Even if such involvement is expressly addressed in the loan documents, this type of control can result in a fiduciary relationship between the lender and borrower. Once the lender becomes a fiduciary, the lender is vulnerable. Theories used to establish such liability include agency, alter ego, and instrumentality.

Lender liability under the common-law theory of agency results when the controlling lender becomes a principal and the borrower becomes its agent. In *A. Gay Jenson Farms Co. v. Cargill, Inc.*,[23] the Minnesota Supreme Court held that the lender, Cargill, Inc. (Cargill), was liable as a principal for the business acts of its borrower, Warren Grain & Seed Co. (Warren).[24] In determining that Cargill exercised de facto control of Warren's operations, the court looked to a number of factors. First, Cargill provided all of Warren's financing for over fourteen years. Second, Cargill had a right of first refusal to purchase Warren's grain, the right to inspect Warren's books, the right to approve dividend declarations and other stock transactions, and the right to approve capital improvements in excess of five thousand dollars.[25] In addition, Cargill constantly gave recommendations and criticisms relating to Warren's finances, officers' salaries, and inventory. Cargill also had the right to enter Warren's premises and conduct periodic checks and audits, and Cargill's name was on all of Warren's financial correspondence. Finally, Cargill had the ability to terminate all of Warren's operating capital.[26]

Although related to the agency theory, the alter ego or instrumentality theory requires a greater degree of lender

23. 309 N.W.2d 285 (Minn. 1981).

24. *Id.* at 291 (citing RESTATEMENT (SECOND) OF AGENCY § 14o (1958)) (stating that a "creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business"). The Restatement further states:

> A security holder who merely exercises a veto power over the business acts of his debtor by preventing purchases or sales above specified amounts does not thereby become a principal. However, if he takes over the management of the debtor's business either in person or through an agent, and directs what contracts may or may not be made, he becomes a principal, liable as any principal for the obligations incurred thereafter in the normal course of business by the debtor who has now become his general agent. The point at which the creditor becomes a principal is that at which he assumes de facto control over the conduct of his debtor, whatever the terms of the formal contract with his debtor may be.

Id. at § 14o comment a.

25. *Jenson*, 309 N.W.2d at 288.

26. *Id.* at 291.

involvement than does the agency theory. Under this second theory, the lender must so dominate the borrower's business that either the borrower becomes the lender's instrument or the lender becomes the borrower's alter ego. In *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.*,[27] the Fifth Circuit Court of Appeals declined to hold the lender liable for its borrower's obligations because the borrower failed to show that the lender was in "actual, participatory, total control."[28] Even though the lender was involved in the borrower's financial management, liquidation of assets, and contractual obligations, the court did not find sufficient evidence to support a jury determination that the borrower had "no separate mind, will or existence of its own."[29]

Lender liability for excessive control resulting in a fiduciary relationship can also be based on other factors, including inequitable use of stock ownership or ownership in addition to other controlling conduct,[30] selection of management, involvement in daily operations or financial management, and use of the borrower's business to achieve the lender's objectives.[31]

2. Special Relationships

A lender may become liable based on the existence of a fiduciary duty, even though it is not substantially involved in its borrower's operations or management. If the lender and borrower are involved in a special relationship of trust or confidentiality, liability premised on fiduciary duty may exist. A lender owes a fiduciary duty to a borrower if their relationship is such that the borrower reasonably relies on the lender to protect the bor-

---

27. 483 F.2d 1098 (5th Cir. 1973).

28. *Id.* at 1109.

29. *Id.*

30. *See, e.g.*, *In re* Process-Manz Press, Inc., 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied sub nom.*, Limperis v. A. J. Armstrong Co., 386 U.S. 957 (1967) (holding that the lender was essentially an owner and, as such, owed a fiduciary duty to the borrower where the lender, holding in excess of 90% of the borrower's stock as collateral for a loan, exercised its control to amend the borrower's articles of incorporation so that the lender could redeem preferred stock, which eliminated $2,000,000 of the financially distressed borrower's working capital). *Cf. Krivo*, 483 F.2d at 1109 (holding that the lender's stock ownership alone does not constitute domination of the borrower).

31. *See generally* Miller et al., *The Fiduciary Duty of Lenders Through Excessive Involvement or Control Over Borrowers in Lender Liability Cases, in* LENDER LIABILITY LITIGATION: RECENT DEVELOPMENTS, 161 (Commercial Law & Practice Course Handbook Series No. 434, 1987).

rower's interests.[32] Courts have found that lenders owe a fiduciary duty to borrowers in a variety of situations. In one instance, a court found a fiduciary duty where a lender induced a borrower to obtain a loan, and then lent the proceeds of that loan to another borrower, who used the loan to pay off an already existing debt to the same lender.[33] Another situation in which such a fiduciary relationship has been found is where, after a twenty-three year banking relationship[34] in which the lender routinely acted as a financial advisor, the lender requested that a borrower obtain a mortgage on real estate to be used as security for an already existing loan; the lender then foreclosed on the property.[35] Finally, in a case where a lender had initially advised a borrower that an investment with a suspected check kiter was sound and later failed to disclose the suspected check kiting scheme, the lender was found to have breached its fiduciary relationship with its borrower.[36]

B. Equitable Subordination

Equitable subordination is a theory that empowers a bankruptcy court to subordinate the claim of a creditor that engaged in inequitable conduct to the claims of other creditors.[37] Bankruptcy courts use equitable subordination as a remedy where the claimant engaged in inequitable conduct and that misconduct resulted in injury to the debtor's creditors or conferred an unfair advantage on the claimant.[38] The applicable test has become

32. A special relationship does not exist, however, where the lender is not aware that the borrower is relying on it to protect the borrower's interests. Klein v. First Edina Nat'l Bank, 196 N.W.2d 619 (Minn. 1972) (holding a lender not liable for failing to inform its borrower that stock pledged as security for a loan to borrower's employer would also serve as the only collateral for any already existing loan to the employer, where lender did not know borrower was relying on it to protect the borrower's interest).

33. Earl Park State Bank v. Lowmon, 161 N.E. 675, 676-78 (Ind. App. 1928).

34. The fact that the lender and borrower have had a business relationship for many years does not by itself give rise to a special relationship. *Klein*, 196 N.W.2d at 623.

35. Stewart v. Phoenix Nat'l Bank, 64 P.2d 101 (Ariz. 1937). The borrower did not, however, prevail on his claim because a prior determination served as res judicata to prevent him from succeeding. *Id.* at 107.

36. Barnett Bank of W. Fla. v. Hooper, 498 So. 2d 923 (Fla. 1986). The court found that the lender's recommendations that the borrower invest, along with the borrower's eight year relationship with the lender, gave rise to a confidential relationship. *Id.* at 924-25.

37. *See generally* Jeremy W. Dickens, Note, *Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of Control*, 65 TEX. L. REV. 801 (1987).

38. Benjamin v. Diamond, 563 F.2d 692, 700 (5th Cir. 1977) (also known as *In re* Mobile Steel Co.).

known as the "*Mobile Steel* test."[39] The type of inequitable conduct usually alleged in equitable subordination cases involves either fraud or breach of fiduciary duty.[40] A creditor may become a fiduciary of its debtor if the creditor exercises sufficient control over the debtor's decision-making processes to constitute domination of the debtor's will.[41] Degrees of lender control can be classified as financial domination, management control, and voting control.

1. Financial Domination

Financial domination of a debtor by a creditor (such as offering business advice and insisting that the advice be implemented, monitoring activities on a daily basis, and imposing other business practices) has not been found to constitute inequitable conduct sufficient to justify subordination of the creditor's claims under the "*Mobile Steel* test."[42]

2. Management Control

Management control of a debtor by a creditor is financial domination of the debtor in addition to indirect control of the debtor creating a fiduciary duty on the part of the creditor.[43] Courts may find that a creditor engaged in inequitable conduct if it exercised management control to a degree that constituted total domination of the debtor.[44]

3. Voting Control

A creditor may be found in direct control of its debtor for purposes of equitable subordination if it exercised its voting power to elect a board of directors that determines and implements the debtor's policies.[45]

C. *Tortious Lender Liability*

When a lender's failure to meet minimum standards of rea-

---

39. *Id.*

40. Roslyn Tom, Note, *Interpreting the Meaning of Lender Management Participation Under Section 101(20)(A) of CERCLA*, 98 YALE L.J. 925, 938 (1989).

41. *Id.*

42. *Id.* at 939-40.

43. Examples of indirect control include supervising the debtor's daily operations, controlling the debtor's assets, and placing management consultants or bank personnel in the debtor company. *Id.* at 940 n.78.

44. *Id.* at 940.

45. *Id.* at 941.

sonable conduct causes injury to its borrower, tort theories are available to establish lender liability.[46] A leading case in this area is *State National Bank v. Farah Mfg. Co.*[47] Farah Manufacturing Company (FMC) was controlled by chief executive officer William J. Farah (Farah) from 1964 until 1976. In 1976 FMC's board of directors demanded that Farah step down.[48] Following Farah's replacement, FMC executed a loan agreement with three lenders containing a clause that prohibited a change in management "which any two Banks shall consider, for any reason whatsoever, to be adverse to the interests of the Banks."[49] FMC continued to sustain losses and, shortly after the loan agreement was signed, Farah proposed to FMC's board of directors that he be reinstated as chief executive officer.[50] When the lenders learned of Farah's proposal, they delivered a letter to FMC's board of directors in which they advised the board that Farah's reinstatement would be unacceptable and that they would not waive their rights under the management change clause if Farah was reinstated.[51] Moreover, representatives of the lenders threatened to "bankrupt the company and padlock it the next day" if Farah was reinstated.[52] At the time the threats were made and the letter was sent, however, the lenders had previously either decided not to declare a default under the loan agreement or had reached no decision on the matter.[53]

As a result of the lenders' threats, Farah withdrew his proposal for reinstatement. Thereafter, FMC's board of directors was comprised primarily of individuals who were affiliated with or proposed by the lenders. Despite this change in management, FMC continued to flounder.[54] When the company's position became desperate, Farah launched a successful proxy battle that led to his reinstatement.[55] A short time after Farah's reinstatement as chief executive officer, FMC returned to profitability.[56] FMC then filed suit against the lenders for fraud, duress, and

46. *See* Freund, *supra* note 6, at 872-79.

47. 678 S.W.2d 661 (Tex. Ct. App. 1984).

48. *Id.* at 670. FMC had just experienced a strike, a nationwide boycott, and substantial operating losses. *Id.*

49. *Id.* at 667.

50. *Id.* at 670.

51. *Id.* at 672.

52. *Id.* at 673.

53. *Id.* at 680.

54. *Id.* at 676-79.

55. *Id.* at 679.

56. *Id.* at 680.

interference; the jury awarded FMC more than eighteen million dollars in damages.[57]

1. Fraud

Generally, to prevail on a fraud claim, a borrower must show that the lender knowingly or recklessly made a false, material representation on which the borrower relied to his detriment. FMC's fraud claim was based upon the lenders' letter, in which they stated they would not waive their rights under the management change clause.[58] This statement constituted a promise the lenders did not intend to perform, however, because they either had decided not to declare a default or had not reached a decision on the matter.[59] A lender may also be held liable under a theory of negligent misrepresentation. This theory generally requires a showing that the lender intentionally made a material misrepresentation, failed to exercise due care, or omitted a fact, which the borrower relied on to his detriment.[60]

2. Duress

A lender may be held liable under a theory of duress or business compulsion when it wrongfully threatens a borrower, depriving the borrower of the exercise of its free will and causing it to do that which it otherwise would not do.[61] FMC's duress claim, like its fraud claim, focused on the letter from the lenders. Although the lenders had the right to declare a default under the management change clause if Farah was elected,[62] the threats were *intended* to manipulate FMC's election of its board of directors unlawfully. The court found that the lenders' threats were made in bad faith and supported a claim for duress.[63]

3. Interference

Historically, a claim for tortious interference was based on a third party's intentional and improper interference in causing a party to a contract not to perform.[64] The *Farah* court expanded

---

57. *Id.* at 667. On appeal, the decision was affirmed although the damage award was reduced from $18,947,348.77 to $18,647,243.77. *Id.* at 699.

58. *Id.* at 666.

59. *Id.* at 686.

60. Freund, *supra* note 6, at 874-75.

61. *Id.* at 875-76.

62. State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661, 686 (Tex. Ct. App. 1984).

63. *Id.* at 684-86.

64. Freund, *supra* note 6, at 876-77.

the tortious interference theory to include interference with corporate governance. FMC's claim was based on the lenders' interference with FMC's election of its board of directors. The court found that the lenders had impermissably interfered with FMC's right to have its affairs managed by competent and loyal directors and officers.[65]

4. Negligence

A lender may be held liable for harm proximately caused by the breach of its duty to exercise reasonable care.[66] For example, a lender was held liable for negligently advising borrowers that they had been approved for Federal Housing Authority (FHA) financing when they had not been so approved.[67] The borrowers discovered that they had not obtained FHA financing after they completed construction of their home and were forced to obtain another loan at a higher interest rate.[68] Although the lender owed no duty to assist the borrowers in obtaining an FHA loan, the court held that it was required to act with due care once it undertook such assistance.[69]

D. Breach of the Duty of Good Faith

Borrowers frequently assert claims against their lenders for breach of the duty of good faith.[70] The Uniform Commercial Code (UCC) defines good faith as "honesty in fact in the conduct or transaction concerned,"[71] and provides that "[e]very contract imposes upon each party a duty of good faith in its performance or enforcement."[72] Similarly, the Restatement (Second) of Contracts provides that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[73]

Lenders have been held to have substantial liability for breaching their duty of good faith in cases involving lines of credit and demand notes. In *K.M.C. Co. v. Irving Trust Co.*,[74]

---

65. *Farah*, 678 S.W.2d at 690.
66. Freund, *supra* note 6, at 878.
67. First Fed. Sav. & Loan Ass'n v. Caudle, 425 So. 2d 1050 (Ala. 1982).
68. *Id.* at 1051.
69. *Id.* at 1052.
70. *See* Freund, *supra* note 6, at 879-85.
71. U.C.C. § 1-201(19) (1990).
72. U.C.C. § 1-203.
73. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).
74. 757 F.2d 752 (6th Cir. 1985).

the Sixth Circuit Court of Appeals held that the lender had violated its duty of good faith when, three years into a lending arrangement in which the borrower, K.M.C. Co., Inc. (K.M.C.), had a 3.5 million dollar line of credit, the lender suddenly refused a routine request for advancement of funds.[75] K.M.C.'s line of credit agreement required that it deposit all of its accounts receivable into a "blocked account," leaving the company wholly dependent upon the lender for its operating capital.[76] Because K.M.C. could not obtain other funds, the company collapsed.[77] The court held that the duty of good faith required the lender to notify K.M.C. of its refusal to advance funds in order to allow the company to obtain alternate financing.[78]

Demand note cases involve situations in which lenders exercise their right to call a demand note at a time that proves to be inopportune for the borrower.[79] Because a demand note's "very nature permits call at any time with or without reason,"[80] some borrowers have been unsuccessful in their attempts to hold their lenders liable for calling their demand obligations.[81] However, some courts have imposed a duty of good faith on lenders despite the express demand provisions in the documents. For example, the *K.M.C. Co.* court imposed liability despite the demand provision in the line of credit agreement.[82]

75. Here, the advance would not have exceeded the $3,500,000 limit. *Id.* at 754. However, a lender is not traditionally obligated to provide funds to the full amount of a line of credit absent a special provision for full funding. *See, e.g.,* Midlantic Nat'l Bank v. Commonwealth Gen., Ltd., 386 So. 2d 31, 33 (Fla. Dist. Ct. App. 1980) (holding that a line of credit "does not impact upon the bank the legal responsibility to loan up to the limit").

76. *K.M.C. Co.,* 757 F.2d at 759.

77. *Id.* at 754.

78. *Id.* at 673.

79. Freund, *supra* note 6, at 882-83.

80. U.C.C. § 1-208 official cmt..

81. *See, e.g.,* Centerre Bank v. Distributors, Inc., 705 S.W.2d 42 (Mo. Ct. App. 1986) (dismissing a borrower's claim of bad faith because it would add a term to which the parties did not agree where the borrower financed the purchase of a highly leveraged business by demand note, a loan officer informed the borrower that continuing financing would present no difficulty, and the lender notified the borrower of its intention to call the note three days after the borrower purchased the business); Flagship Nat'l Bank v. Gray Distribution Sys., Inc., 485 So. 2d 1336 (Fla. Dist. Ct. App. 1986) (holding that an obligation of good faith could not be imposed to override an express contract provision which stated that the note could be called on demand).

82. K.M.C. Co. v. Irving Trust, Co., 757 F.2d 752, 760 (6th Cir. 1985).

II. CERCLA AND SARA

In 1980, Congress enacted CERCLA to provide federal authority to prevent or remedy the growing problem of hazardous waste contamination throughout the nation.[83] The purposes of the Act were to take control of the mammoth hazardous waste problem,[84] by encouraging cleanup of abandoned hazardous waste sites,[85] and to prevent further contamination of the environment.[86] By enacting CERCLA, Congress attempted to place the primary responsibility for cleanup upon those who created the problem.[87] CERCLA was the product of three years of congressional effort to address the growing problem of hazardous waste releases and was enacted as a "last-minute compromise" between three competing bills.[88] As a result, the statute's legislative history is vague and incomplete, prompting courts to describe it as "sparse"[89] and "shrouded with mystery."[90] The lack of clear language in the statute, along with the fact that CERCLA created an entirely new area of liability for which no real precedent exists, contributed significantly to lenders' confusion as to how to avoid liability. CERCLA authorizes the Environmental Protection Agency (EPA) to target waste sites throughout the nation through the development of the National Priorities List (NPL).[91] EPA uses the NPL to prioritize the sites in accordance with the seriousness of the hazard and to determine the order in which those sites will be cleaned up.[92] By 1990, EPA had placed over one thousand sites on the NPL and had proposed over two hundred additional sites to be placed on

---

83. *See generally* Tom, *supra* note 40.

84. *See* H.R. REP. No. 1016, 96th Cong., 2d Sess. 17-18 (1980), *reprinted in* 1980 U.S.C.C.A.N. 6119, 6120.

85. *Id.* at 27-28, *reprinted in* 1980 U.S.C.C.A.N. at 6130-31.

86. *Id.* at 30, *reprinted in* 1980 U.S.C.C.A.N. at 6133.

87. *Id.* at 33, *reprinted in* 1980 U.S.C.C.A.N. at 6136.

88. Although Congress worked on related legislation for over three years, the bill that actually became law was hastily compiled, compromised, and passed during the lame duck session of the outgoing Carter Administration in 1980. Frank D. Grad, *A Legislative History of the Comprehensive Environmental Response, Compensation and Liability ("Superfund") Act of 1980*, 8 COLUM. J. ENVTL. L. 1, 1 (1982).

89. United States v. Maryland Bank & Trust Co., 632 F. Supp. 573, 578 (D. Md. 1986); United States v. Fleet Factors Corp., 901 F.2d 1550, 1558 n.11 (11th Cir. 1990), *cert. denied*, 111 S.Ct. 752 (1991).

90. Dedham Water Co. v. Cumberland Farms Dairy, Inc., 805 F.2d 1074, 1081 (1st Cir. 1986).

91. 42 U.S.C. § 9605.

92. *Id.* 40 C.F.R. § 300.425 (1990).

the list.[93] CERCLA also created a 1.6 billion dollar "Superfund,"[94] largely subsidized by excise taxes levied upon the chemical and petroleum industries to allow the government to clean up hazardous waste sites.[95] In 1986, Congress enacted SARA,[96] which provided an 8.5 billion dollar increase to the Superfund to address the increasing number of potential Superfund sites,[97] and contained other amendments to the substantive provisions of CERCLA, some of which are discussed below.

A. Liability

The liability imposed by CERCLA is strict,[98] joint and several,[99] and retroactive.[100] Liability under CERCLA is determined by section 107 of the Act,[101] under which four classes of parties (commonly referred to as potentially responsible parties or PRPs) are potentially responsible for the costs of cleaning up a site:

> (1) the owner or operator of a vessel or facility,
> (2) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of,
> (3) any person who by contract, agreement, or otherwise arranged for disposal or treatment, or arranged with a transporter for transport or disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances, and

---

93. Turner T. Smith, et al. *Environmental Considerations in Project Financing, in* PROJECT FINANCING 1990: POWER GENERATION, WASTE RECOVERY, AND OTHER INDUSTRIAL FACILITIES 591, 609 (Real Estate Law & Practice Course Handbook Series No. 345, 1990).

94. The fund is labeled the "Hazardous Substance Superfund" under current legislation. 42 U.S.C. § 9601(11).

95. 42 U.S.C. § 9611(p); 26 U.S.C. § 9507.

96. Pub. L. No. 99-499, 100 Stat. 1613 (1986) (codified as amended in scattered sections of 26 U.S.C. and 42 U.S.C.).

97. H.R. REP. No. 253, 99th Cong., 2d Sess. 54 (1986), *reprinted in* 1986 U.S.C.C.A.N. 2835, 2836.

98. *See, e.g.*, New York v. Shore Realty Corp., 759 F.2d 1032, 1042 (2d Cir. 1985).

99. *See, e.g.*, United States v. Chem-Dyne Corp., 572 F. Supp. 802, 811 (S.D. Ohio 1983).

100. *See, e.g.*, United States v. Shell Oil Co., 605 F. Supp. 1064, 1072-73 (D. Colo. 1985).

101. 42 U.S.C. § 9607.

(4) any person who accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from where there is a release or threatened release which causes the incurrence of response costs.[102]

Section 107 provides that the four classes of PRPs are liable subject only to three express statutory defenses.[103] The statutory defenses provide that a party will not be held liable for a release caused by an act of God,[104] an act of war,[105] or an act or omission of a third party other than an employee or agent of the defendant, or a party in a contractual relationship with the defendant.[106] The first two defenses leave little room for legal creativity or flexibility. The last of the three statutory defenses is the only one that was not defined narrowly and that could potentially have broad application. This so-called third party defense does not, however, provide much protection.[107]

B. The Third Party Defense And The Innocent Landowner Defense

In order to establish a defense under section 107(b)(3), a lender must show: (1) that the release of hazardous substances was caused solely by the act or omission of a third party other than (a) an employee or agent of the lender, or (b) a person whose act or omission occurred in connection with a contractual relationship existing directly or indirectly with the lender; (2) that the lender exercised due care with respect to the hazardous substance concerned; and (3) that the lender took precautions against foreseeable acts or omissions of third parties and the foreseeable consequences of such acts.[108]

The first component of the third party defense has received much attention because it is the most difficult to satisfy.[109] To qualify for the defense, a lender must prove that none of its agents or employees participated in or contributed to the release

102. *Id.* § 9607(a).
103. *Id.* § 9607(b).
104. *Id.* § 9607(b)(1).
105. *Id.* § 9607(b)(2).
106. *Id.* § 9607(b)(3).
107. *See* Elizabeth A. Glass, *Superfund and SARA: Are There Any Defenses Left?*, 12 HARV. ENVTL. L. REV. 385, 461 (1988).
108. 42 U.S.C. § 9607(b)(3).
109. Michelle B. Corash & Lawrence B. Behrendt, *Lender Liability Under CERCLA: Search for a Safe Harbor*, 43 SW. L.J. 863, 875 (1990).

of hazardous substances.[110] The most controversial element of the first component, however, is the lender's burden to prove that it had no direct or indirect contractual relationship with any person whose act or omission caused the release. Thus, if a real property deed qualifies as a contractual relationship, the defense would be unavailable to a party who purchased contaminated property from a seller who caused the contamination, and to a seller of contaminated property if the purchaser contributed to the contamination.[111]

In response to well-publicized cases that focused congressional attention on the lack of clarity in the "contractual relationship,"[112] and on what was generally perceived as inequitable results against "bagholders,"[113] Congress amended the defense in the 1986 SARA amendments. Presumably the idea of the new "innocent landowner defense" was to avoid the appearance of "no-win" situations for parties who may have had nothing to do with the original events leading to CERCLA liability, while encouraging investigation on the part of anyone who might potentially hold or get title to a "vessel/facility" as defined by the statute.

The innocent landowner defense did not replace the general liability provisions for "owners and operators" under section 107(a).[114] However, it *did* alter the definition of "contractual relationship" from the third party defense in section 107(b)(3). Besides meeting the requirements already in existence,[115] the landowner must meet the statutory requirements of "innocence." To do this, he must have had "no reason to know" of hazardous substance violations there.[116] The 1986 addition states, "[t]o establish that the defendant had no reason to know

---

110. *Id.*

111. *Id. See also* United States v. Hooker Chem. & Plastics Corp., 680 F. Supp. 546, 558 (W.D.N.Y. 1988) (holding that a real property deed could create a contractual relationship under 42 U.S.C. § 9607(b)(3)).

112. Elizabeth Dawner, Comment, *Buying into Trouble-Lender Liability under CERCLA and SARA*, 14 S. Ill. U. L.J. 319, 320 (1990).

113. *See, e.g.*, United States v. Maryland Bank & Trust Co., 632 F.Supp. 573, 581 (D. Md. 1986) (holding that even lenders who do not become involved with borrowers' daily activities may be liable under CERCLA).

114. 42 U.S.C. § 9607(a).

115. *Id.* § 9607(b)(3)(a)-(b).

116. *Id.* § 9601(35)(A)(i). Section 9601(35)(A) also specifically covers government entities "which acquire the property through escheat, involuntary transfer or acquisition, or eminent domain," *Id.* (35)(A)(ii), and covers those who "acquired the property by inheritance or bequest." *Id.* (35)(A)(iii).

. . . , the defendant must have undertaken, at the time of acquisition, all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice in an effort to minimize liability."[117]

Although SARA authorizes the court to consider several specific factors in its evaluation of the propriety of the defendant's inquiry (for example, any special knowledge or experience of the defendant, the obvious or likely presence of contamination, and the ability to detect the contamination by appropriate inspection),[118] the Amendment provides no guidance as to what "good commercial or customary practice" is intended to mean.

The usability of such a standard, by itself, is doubtful. Like so much of CERCLA, this vague language leaves parties unsure as to what is required while leaving courts great latitude in determining what is required after the fact. Ironically, if a lender was too diligent in this inquiry, he could very easily lose the protection he is seeking via this defense. In additon, one would think that the language of section 101(35)(B) envisions furthering good faith in the parties involved. A realistic application of this defense calls its effectiveness into question. Indeed, there is an incentive for a lender to prematurely cease inquiries, before he learns too much, and to hope he has already passed the "due diligence" threshold. Lenders face a strong temptation to perjure themselves as to what they discover. When one considers the huge sums of money involved in being found a PRP, it is understandable how this could motivate desperate action.

Case law is less than helpful in defining "all appropriate inquiry." One court noted that site visits and investigations into past and present condition of the property[119] are not always necessary to maintain the shield of the innocent landowner defense. Another court, however, held that only contracting two firms to do an environmental audit before purchasing property is insufficient.[120] What guidance does this give lenders seeking a method

117. *Id.* § 9601(35)(B).

118. *Id.*

119. *See, e.g.,* United States v. Serafini, 711 F. Supp. 197 (M.D. Pa. 1988); United States v. Pacific Hide & Fur Depot, Inc., 30 Envt. Rep. Cas. (BNA) 1082 (D. Idaho 1989). In *Pacific Hide*, an inheritance case, the court noted that a complete lack of inquiry did not preclude use of the innocent landowner defense. The court said a reduced scrutiny was more fitting for noncommercial transactions. Obviously, this is of little use to lenders in foreclosure situations.

120. *See, e.g.*, BCW Associates, Ltd. v. Occidental Chemical Corp., No. 86-5947, 1988 U.S. Dist. LEXIS 11275 (E.D. Pa., Sept. 29, 1988). In *BCW*, the court seemed to be

for approaching security interest situations? In a conference paper, James C. Morriss III and Elizabeth Webb suggest prospective purchasers should, at a minimum, undertake the following:

> 1) conduct an actual, on site, inspection of the property and the adjoining property;
> 2) conduct an inquiry of prior site operators and owners;
> 3) conduct an inquiry into prior uses of the site and adjoining property;
> 4) review all available public or governmental records with respect to any prior reports or threats of contamination at the site; and
> 5) conduct an environmental assessment, if warranted by the above . . . (it is imperative that environmental assessments be reviewed with a critical eye).[121]

Of course lenders must also remember that they remain liable if they transfer title when they have found hazardous substances at the site after foreclosure, and do not disclose the information to the purchasers.[122]

State of Washington v. Time Oil Co. addressed the innocent landowner defense in the context of section 107(b) of CERCLA and noted that a defendant seeking to avail himself of this defense, must show that complete responsibility for the release of hazardous substances lay with those unconnected to the subsequent owners.[123] The violation must be solely at the hands of others.

Lenders are left with vague statutory language that commentators believe constitutes a lack of guidance, which rather

---

saying that certain factors which the auditors missed should have been enough to give notice of problems to the company. *Id.* at *18. The case acts as a warning that negligence by outside consultants can be imputed to the hiring company (leaving the company to seek contribution in a separation action, which may not be sufficient to cover the CERCLA cleanup costs).

121. James C. Morriss, III & Elizabeth Webb, Recent Developments Under CERCLA, 11 (unpublished manuscript, on file with the *Tulane Environmental Law Journal*) (Conference paper from Environmental Law and Environmental Science for Lawyers, University of Houston Law Center, May 31 - June 1, 1990); *see also* Grover C. Wrenn & Joyce S. Schlesinger, Assessment of Environmental Liabilities app. at D-Z (unpublished manuscript, on file with *Tulane Environmental Law Journal*) (from the same conference, regarding what environmental audits should include, potential problem areas, and level of review for different kinds of clients).

122. 42 U.S.C. § 9607(a).

123. 687 F. Supp. 529, 533 (W.D. Wash. 1988). Time Oil failed to show that those persons who were responsible for the releases had "no employment, subsidiary, or contractual connection" with the company. *Id.*

than solving the problem, simply adds another layer to the atmosphere of uncertainty as to how lenders can protect themselves from liability.[124] This vague statutory language is coupled with contradictory caselaw. At the present time, lenders who want to successfully employ the innocent landowner defense, would be wise to take the most stringent suggestions from experts and judges and adopt the most cautious interpretation of the statute.

C. The Secured Creditor Exemption

An owner or operator is a PRP under CERCLA's liability provisions. The term "owner or operator" means "in the case of . . . [a] facility, any person owning or operating such facility," but "does not include a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility."[125] Thus, Congress created an exemption from liability for persons, such as lenders, who hold "indicia of ownership" to protect their security interests and who do not "participate in management." This exemption is commonly referred to as the secured creditor exemption, and it forms the basis for most lenders' efforts to avoid liability under CERCLA. However, neither the statute nor its legislative history provides any guidance as to what level of participation in management is sufficient to remove a lender from the protection of the exemption.

In the 1986 SARA Amendments, Congress amended the term "owner or operator" to exclude from liability state and local governments that "acquired ownership or control involuntarily through bankruptcy, tax delinquency, abandonment, or other [similar] circumstances."[126] Under the Amendments, Congress also included in the definition of the term owner or operator "any person who owned, operated or otherwise controlled the activities immediately beforehand" in the case of "any facility, title or control of which was conveyed due to bankruptcy, foreclosure, tax delinquency, abandonment, or similar means to a unit of State or local government."[127]

Some commentators believe that the fact that Congress did not also amend the term to exclude from liability lenders that

---

124. *See, e.g.*, Dawner, *supra* note 112, at 321.
125. 42 U.S.C. § 9601(20)(A).
126. *Id.* § 9601(20)(D).
127. *Id.* § 9601(20)(A).

acquire contaminated property through foreclosure indicates that it intended that liability should extend to such lenders.[128] The "foreclosure as owner" problem affects lenders on the same scale as "participation in management," and is similarly unsettled.

Just as holding a security interest in a borrower's business is an integral part of the loan process, so too is the concept that the interest must have some value if it is to be worthwhile for that purpose. If the operation in question is involved in some way with hazardous wastes, then the possibility escalates enormously that the security interest will not only not have a market value by the time the bank comes to own it, but that it will actually turn out to be a tremendous liability. Under CERCLA, this is the dilemma that faces lenders who have defaulting borrowers and must determine whether to foreclose.

The strict liability standard which CERCLA imposes on owners of operations who may not even be responsible for the release of hazardous wastes is clear,[129] subject to the limitations of the innocent landowner defense.[130] Once the lender's title has ripened, that lender is an "owner"; it no longer matters if he is involved in the management of the operation or not.[131]

According to *United States v. Maryland Bank & Trust*

128. *See* Tom, *supra* note 40, at 926; *see also* Carolyn Rashby, Note, United States v. Maryland Bank & Trust Co.: *Lender Liability Under CERCLA*, 14 ECOLOGY L.Q. 569, 583-85 (1987).

129. *See* United States v. Moore, 698 F. Supp. 622, 624 (E.D. Va. 1988).

130. The SARA Amendments codified this defense in 1986. 42 U.S.C. § 9601(35).

131. There *does* seem to be a grace period however. The recent EPA proposed draft rule points out that "[f]oreclosure and possession of property incident to sale or liquidation is often the only remedy the holder of a security interest may have to secure performance of an obligation. Accordingly, several courts construing § 101(20)(A) have indicated that the mere foreclosure and taking of title does not necessarily void the exemption." *Proposed Draft Rule On Lender Liability Under CERCLA With Accompanying Letter From EPA To OMB*, 21 Env't. Rep. (BNA) 1908, 1917 (Jan. 24, 1991) [hereinafter *Proposed Draft Rule*] (citing United States v. Mirabile, 15 Envtl. L. Rep. (Envtl. L. Inst.) 20,994 (E.D. Pa. Sept. 4, 1985); United States v. Maryland Bank & Trust Co., 632 F. Supp. 573 (D. Md. 1986); *In re* T.P. Long Chemical, Inc., 45 B.R. 278 (Bankr. N.D. Ohio 1985); observing however that Guidice v. BFG Electroplating & Mfg. Co., 732 F. Supp. 556 (W.D. Pa. 1989) does not follow this rule). The text further notes that "While mere foreclosure is considered permissible, a security holder that does not endeavor to sell or otherwise divest itself of foreclosed-on property runs the risk that it will be considered to be possessing the property as an investment, and not as protection for a security interest." *Proposed Draft Rule*, *supra* at 1917, (citing *Maryland Bank & Trust*). However, the text correctly concludes that "existing caselaw does not provide further guidance regarding the period of time that is considered reasonable for a holder to maintain foreclosed-on property." *Id. See infra* note 139 and accompanying text (discussing the way the proposed rule would formalize and standardize the grace period).

Co.,[132] a principal case in this area, the lender's security interest must exist at the time of the cleanup of the toxic waste; if at that time the lender holds full title, the secured creditor exemption does not apply.[133] In the *Maryland Bank* case, the debtor defaulted on its note for the purchase price of the property, and the lender foreclosed. EPA initiated investigations and cleanup activities at the site. EPA then brought suit against the bank to recover its expenditures. The court's reasoning was that the exemption[134] was meant to protect secured creditors who, in compliance with state law, hold title to the security interest. This seems to imply that the exemption is a way of narrowing the definition of "owner." There was concern that lenders, if not liable in these situations, would simply purchase the operation cheaply at the foreclosure sale (the other bidders being subject to liability); after the government has cleaned up and paid for it, that lender could then reap full profit from the operation as title-holder, at the expense of the taxpayers.[135]

The court's attitude toward lenders showed a desire to have that industry take full responsibility for these situations, not simply exploit them.

> Mortgagees . . . already have the means to protect themselves, by making prudent loans. Financial institutions are in a position to investigate and discover potential problems in their secured properties. For many lending institutions, such research is routine. CERCLA will not absolve them from responsibility for their mistakes of judgment.[136]

There was a certain amount of leeway in this opinion in that the court was not addressing the lender who received title and immediately divested himself of it.[137] Here, however, the bank held title for four years and was thus excluded from claiming the exemption because its actions were classified as protecting an

132. 632 F. Supp. 573 (D. Md. 1986). Note that in *Maryland Bank & Trust* the lender's mortgage loan of $335,000 ended up costing the bank more than $550,000 for response costs after foreclosure and subsequent determination of CERCLA liability.

133. *Id.* at 579. *Cf. In re* T.P. Long Chemical, 45 B.R. at 288-89 (suggesting in dicta that even a bank which has repossessed may not be an "owner or operator" as defined under CERCLA). However, *Maryland Bank & Trust* is the more significant case and is followed more frequently.

134. 42 U.S.C. § 9601(20)(A).

135. *Maryland Bank & Trust Co.*, 632 F. Supp. at 580.

136. *Id.*

137. In *Mirabile*, the district court found a lender free from liability when he divested himself of the property four months after the foreclosure sale. United States v. Mirabile, 15 Envtl. L. Rep. (Envtl. L. Inst.) 20,994 (E.D. Pa. Sept. 4, 1985).

investment rather than a security interest. According to Professor Jeffrey Gaba of Southern Methodist University School of Law, "[A]mendments to CERCLA since *Maryland* and *Mirabile* may substantially limit the ability of any lender who acquires title through foreclosure to avoid liability."[138] On the other side, however, are the changes that may be implemented by recently proposed EPA draft rules.[139]

In *Guidice v. BFG Electroplating & Mfg. Co.*,[140] the court followed the reasoning in *Maryland* and held that lenders acquiring operations in foreclosure sales could not avail themselves of the CERCLA security interest exemption for they had become "owners" in the eyes of the statute, and were therefore liable. In that case, National Bank's actions before the foreclosure, but after the default by Berlin Metals, were held to be acceptable under the "participation in management" analysis of the secured creditors exemption. The court focused on when the bank took title to the property after the foreclosure.[141]

The *Maryland* concern of lenders getting a special advantage at these sales was echoed in *Guidice*: there should not be a special class of people who would otherwise be liable unless specifically provided for by Congress.[142] Accordingly, the *Guidice* court pointed to specific exemptions for "involuntary owners"[143] which were added in the SARA Amendments, and the absence of a similar exemption for lenders with perfected security interests.

---

138. *See generally* Jeffrey M. Gaba, Lender Liability for Hazardous Waste Cleanup, (unpublished manuscript on file with the *Tulane Environmental Law Journal*) (submitted for Conference on Environmental Litigation: Effective Strategies, Emerging Issues, Constituent Communication; South Texas College of Law, Jan. 18-19, 1990).

139. EPA's proposed draft rule would formalize the grace period that emerged through several court interpretations of § 101(20)(A). "A foreclosing security holder that maintains possession of a facility for *six months or fewer* after foreclosure is presumed to have taken possession of the facility primarily to protect its security interest, and not for some other purpose inconsistent with the exemption, provided that the security holder did not participate in the management of the facility prior to foreclosure." *Proposed Draft Rule*, *supra* note 131, at 1917.

140. *Id.* (emphasis added); 732 F. Supp. 556, 563 (W.D. Pa. 1989).

141. *Id.*

142. *See* Brady S. Tupi, Guidice v. BFG Electroplating: *Expanded CERCLA Liability for Foreclosing Lenders*, 4 Toxics L. Rep. (BNA) 844, 846 (Dec. 20, 1989) for a fact-specific objection to this holding. According to Morriss and Webb, Tupi seems to attack what is essentially a policy decision by relying on the specific facts of this case. *See* Morriss & Webb, *supra* note 121, at 18.

143. 42 U.S.C. § 9601(20)(A) (concerning ownership acquired by state and local governments by way of bankruptcy, tax delinquency, abandonment or similar situations).

III. Interpreting Participation in Management Under Section 101(20)(A)

The aforementioned discussions in Congress show a push to extend meaningful protection to lenders under the secured creditor exemption.[144] However, until the changes to CERCLA are actually made lenders will have to function under the already existing jurisprudence. This caselaw constitutes efforts to glean intention from the vague language of the statute, and therefore is often contradictory. However, because of the current unsettled state of proposed CERCLA amendments, the following coverage of this caselaw's development is valuable to demonstrate the present state of the law in this area.

A. *Caselaw Development of "Participation In Management" by Lenders*

The secured creditor exemption in CERCLA contains the following phrase which is the key to understanding this genre of case: an operator "does not include a person who, without participating in the management of a vessel or facility, holds indicia of the ownership primarily to protect his security interest in the vessel or facility."[145] Common-law development of lender liability in security interest Superfund situations has focused on a determination of whether the lender's actions and intentions have crossed this threshold.

The issue was first addressed in *United States v. Mirabile,*[146] where the lender's *financial* management of the borrower's business affairs[147] was distinguished from participation in management of the facility itself.[148] The district court considered the potential CERCLA liability of three creditors: the Small Business Administration (SBA), American Bank & Trust (ABT), and Mellon Bank. The trial judge analyzed the degree of management participation exercised by each creditor to determine if its involvement went beyond protection of a security interest. Since the SBA never exercised its rights of participation, the court found them not liable.[149] The court considered ABT's

144. *See supra* notes 127-143 and accompanying text.

145. 42 U.S.C. § 9601(20)(A).

146. 15 Envtl. L. Rep. (Envtl. L. Inst.) 20,994 (E.D. Pa. Sept. 4, 1985).

147. *See* Tom, *supra* note 40, at 929 (discussing activities which may be classified as "management participation").

148. *Id.* at 995-6.

149. *Mirabile*, 15 Envtl. L. Rep. (Envtl. L. Inst.) at 20,995-96. The SBA's loan

actions during the foreclosure process to be proper in order to protect its security interest and granted its request for summary judgment.[150] The actions of the third creditor, Mellon Bank, created a "cloudier situation."[151] As the creditor's business deteriorated, Mellon officers became increasingly involved with the management of the facility.[152] Still, the court considered the bank's monitoring of cash accounts, tracing receivables to proper accounts, and requiring regular reporting, as financial management not giving rise to CERCLA liability.[153] However, the involvement of Mellon's officers with nonfinancial aspects of the business precluded the granting of a summary judgment in Mellon's favor.[154] Mellon's officers decided the sequence of filling orders, demanded additional sales efforts, changed certain manufacturing processes, reassigned personnel, and insisted that the debtor accept daily supervision.[155] The court considered these activities operational in nature and beyond the involvement necessary to protect a security interest.[156]

This decision displays a less than literal interpretation of "participation in management" by the court, and acts as a good example of how judges have legislated their own standards for levels of management participation into Superfund law.

The opinion articulates how the problem was perceived:

> The exemption plainly suggests that provided a secured creditor does not become overly entangled in the affairs of the actual owner or operator of a facility, the creditor may not be held liable for cleanup costs. The difficulty arises, of course, in determining how far a secured creditor may go in protecting its financial interests before it can be said to have acted as an

---

agreement contained several provisions allowing some involvement with management and restructing the use of loan proceeds.

150. *Id.* at 20,996. ABT secured the facility against vandalism, inquired into removal costs for the hazardous waste, and showed the property to various prospective buyers; *see also* Guidice v. BFG Electroplating & Mfg., Co. 732 F. Supp. 556, 562 (W.D. Pa. 1989) (holding that regular meetings with the debtor's management, assisting the debtor in finding additional financing, communicating with local officials on debtor's behalf, inspecting the facility after operations stopped, restructuring loans, and agreeing to finance a third party's purchase of the facility at foreclosure were prudent measures to protect a security interest).

151. *Mirabile*, 15 Envtl. L. Rep. (Envtl. L. Inst.) at 20,997.

152. *Id.*

153. *Id.*

154. *Id.* at 20,994.

155. *Id.* at 20,997.

156. *Id.*

owner or operator within the meaning of the statute.[157]

Thus, there appears to be an inconsistency: Couldn't the lender become "overly entangled" in the financial "affairs" of the owner or operator, and thus incur liability by the court's reasoning as stated in this passage? Is the standard going past financial involvement, or is it merely any involvement that is "overly entangled"? This point was never satisfactorily resolved by the court.

The opinion found secured creditor involvement in the actual day-to-day operation of the site to be the minimum standard for liability.[158] The mere authority to participate in such management was not, of itself, sufficient. The practices of "monitoring the cash collateral accounts, assuring that receivables went to the proper account, and establishing a reporting system between the company and the bank" were not enough.[159] The internal incongruity of this opinion, the fact that this court appeared to be adding to the statute, and later higher court decisions make *Mirabile* a questionable basis for lenders to use as a guide in this area. The rule-of-thumb for a secured creditor is that the more distance he can put between himself and the daily management decisions at a facility (particularly those involving hazardous wastes), the better off the secured creditor will be from a CERCLA liability standpoint. Further case law will determine if the "financial" distinction set up in this case will remain in effect and if it does, what form it will take.[160] The issue of mere authority to influence management of the facility being sufficient to incur liability undergoes radical and important changes in later decisions in higher courts.

The recent case of *United States v. Fleet Factors Corp.*[161] effectively reversed a portion of *Mirabile.* The creditor in that case was Fleet Factors Corporation (Fleet). The debtor, Swainsboro Print Works (SPW), operated a cloth printing plant. Fleet provided SPW with working capital loans backed primarily by SPW's accounts receivable. As additional collateral, Fleet took a security interest covering SPW's property, plant, and equipment. When SPW declared bankruptcy and a trustee assumed title and control of the facility, Fleet foreclosed on some inven-

157. *Id.* at 20,995.
158. *Id.* at 20,996.
159. *Id.* at 20,997.
160. Gaba, *supra* note 138, at 7.
161. 901 F.2d 1550 (11th Cir. 1990), *cert. denied*, 111 S. Ct. 752 (1991).

tory and equipment at the site. A liquidator was contracted to auction off the collateral, and a salvage company was brought in to remove the unsold equipment and clean up the premises. A month after the salvage company completed its operation, EPA inspected the facility and discovered seven hundred drums containing hazardous substances, and forty-four truckloads of asbestos-laden material. EPA removed the hazardous materials and brought suit to recover the response costs of four hundred thousand dollars.

The district court declined to find Fleet liable as present owner of the facility.[162] In terms of "operator" liability, the auction turned out to be the pivotal point on the time line. The court held as a matter of law that Fleet's actions before the auction were not sufficient to establish operator liability, but that there was a fact issue as to the characterization of Fleet's actions after the auction. Therefore, Fleet could not be granted a summary judgment.[163]

Before the auction, Fleet checked the credit of SPW's customers before shipments, foreclosed upon some of SPW's equipment and inventory, and contracted with the auction company to sell that equipment and inventory. All of these acts were found by the court to be acceptable under the secured creditor exemption.[164] After the auction, Fleet had the auctioneer move barrels containing hazardous materials away from the auction area, and allowed asbestos to be disturbed as purchasers removed their acquisitions from the auction grounds and a salvage company removed the remaining equipment. Though these actions precluded the district court's issuance of a summary judgment,[165] it adopted the position taken by other courts[166] that, in order to lose the exemption, a secured party must "participate in the day-to-day management of the business."[167]

On appeal, the appellate court agreed that Fleet was not

162. United States v. Fleet Factors Corp., 724 F. Supp. 955, 960 (S.D. Ga. 1988).

163. *Id.* at 960-61.

164. *Id.* at 960.

165. *Id.* at 960-61.

166. *See, e.g.*, United States v. Nicolet Inc., 712 F. Supp. 1193, 1205 (E.D. Pa. 1989) (holding that a secured creditor can only be liable under CERCLA if it participated in the operational aspects of management); Guidice v. BFG Electroplating & Mfg. Co., 732 F. Supp. 556, 561 (W.D. Pa. 1989) (holding that a secured creditor is exempt from CERCLA liability as long as it does not manage or interfere with the operation of the facility); United States v. Mirabile, 15 Envtl. L. Rep. (Envtl. L. Inst.) 20,994, 20,995 (E.D. Pa. Sept. 4, 1985).

167. *Fleet Factors*, 724 F. Supp. at 960.

liable as the current owner of the site.[168] However, it rejected the lower court's construction of the participation limitation and held that "a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose."[169] The court cited "the sparse legislative history" of CERCLA in support of this view.[170]

The *Fleet Factors* holding stated that "a secured creditor will be liable if . . . it could affect hazardous waste disposal if it so chose,"[171] whereas *Mirabile* held that simply having the power to effect day-to-day management decisions was not enough. Clearly, at least in the realm of dealing with the hazardous waste end of the business in question, covenants which grant authority to the lender to exercise operational control can lead to CERCLA liability for the lender, whether they were ever enforced or not. Further, even *financial* covenants in standard loan documents could potentially have this effect,[172] in which case *Fleet* would have effectively overruled *Mirabile* almost completely.

The holding in *Fleet Factors* is the first time a federal appellate court addressed the "participation in management" wording of the security interest exemption,[173] though there are several lower court opinions on the subject.[174] The United States Supreme Court refused to hear *Fleet Factors* in February of 1991. Because *Fleet Factors* is currently the highest level opin-

---

168. United States v. Fleet Factors Corp., 901 F.2d 1550, 1555 (11th Cir. 1990).

169. *Id.* at 1558 (emphasis added).

170. *Id.* at 1558 n.11.

171. *Id.* at 1558.

172. *See* Richard G. Leland, *Lender Liability in Cleanups Presents Workout Dilemma*, AM. BANKER, June 20, 1990, at 4 (proposing that the power to affect hazardous waste decision-making could even be inferred from strict provisions dictating lender financial control); Stephen Kleege, *Court Ruling on Liability May Spook Wary Banks*, AM. BANKER, May 30, 1990, at 1 (proposing that the *Fleet* decision opens up lenders to CERCLA liability in normal lending proceedings).

173. United States v. Fleet Factors, Corp., 901 F.2d 1550, 1556 (11th Cir. 1990) (noting that this is the first time that a federal appellate court has treated the issue); *see also* Hill v. East Asiatic Co. (*In re*, Bergsoe Metal Corp.), 910 F.2d 668, 672 (9th Cir. 1990) (noting that *Fleet Factors* is the first time that a federal appellate court has treated the issue).

174. *See* Guidice v. BFG Electroplating & Manufacturing, Co., 732 F. Supp. 556, 561 (W.D. Pa. 1989) (noting that actual lender participation is required in the management of the facilites' operation before CERCLA liability would be assessed); and United States v. Nicolet, Inc., 712 F. Supp. 1193, 1205 (E.D. Pa. 1989) (noting that actual lender participation is required in the management of the facilities' operation before CERCLA liability would be assessed).

ion on lender participation in management, it would seem that the common-law development of this part of Superfund law has taken a decisive step toward the lender's coffer.[175]

The Supreme Court's refusal to grant certiorari in the *Fleet Factors* decision may reflect a recognition of the fact that although a muddy situation exists, it is one which should be clarified by congressional action rather than judicial "legislation." It appears that the ball is now in Congress's court. As the recent hearings suggest, there is some congressional attention being paid to this unsettled view of "participation in management." However, although Congress has recognized this ambiguity, it has yet to pass a law clarifying it. Before setting specific guidelines for purposes of the secured creditor exemption, Congress must first determine whether the scope of management participation should be broadly or narrowly construed.[176] The following sections suggest a logical and equitable path for Congress to take.

B. The Impact of Judicial Interpretations

The cases interpreting the extent of a lender's liability under CERCLA[177] have generated so much controversy and confusion that Congress held two hearings[178] to hear testimony on the impact of judicial interpretations of lender liability under CERCLA. A summary of the results of the testimony follows.

1. Lenders and Small Businesses

Judicial interpretations holding lenders liable for cleanup costs have resulted in increasing refusals by many lending insti-

---

175. In the case *In re Bergsoe Metal Corp.*, 910 F.2d at 672, the 9th Circuit Court in dicta interpreted *Fleet Factors* to mean that participation in financial management is itself insufficient to incur liability, but a lender would be liable under CERCLA if it participated in the day-to-day or operational management of a facility. That is not the common interpretation of *Fleet Factors*, however. Also, the unique facts of the case make it less likely to be effectively used to counter *Fleet Factors*: the lender was only holding bonds for a project as trustee, and the company went under so quickly that the bank never even had a chance to exercise its "potential to manage" covenants. *Id.*

176. *See* Tom, *supra* note 40, at 928 (comparing the consequences which would result from adoption of narrow and broad interpretations of the term "management participation").

177. *See, e.g.*, Maryland Bank & Trust, 632 F. Supp. 573 (D. Md. 1986); Guidice v. BFG Electroplating & Mfg. Co., 732 F. Supp. 556 (W.D. Pa. 1989); *Fleet Factors*, 901 F.2d 1550 (11th Cir. 1990), *cert. denied*, 111 S. Ct. 752 (1991).

178. The hearings were held on August 3, 1989 and June 7, 1990. H.R. REP. NO. 1003, 101st Cong., 2d Sess. 139 (1991).

tutions to lend to creditworthy small businesses that use hazardous materials, or are located on or near property that is possibly contaminated.[179] The potential for millions of dollars of liability for cleanup costs has created such an increase in the risk of loss that lenders are no longer willing to assume that risk by lending to businesses that use hazardous materials or are located near areas of possible contamination.[180]

The result is that many well-managed small businesses,[181] with otherwise acceptable credit ratings, that must rely on their property, plant, and equipment to secure a loan cannot obtain the financing they need to survive.[182] Such small businesses have found that the potential for environmental cleanup liability has also caused lenders to balk at providing the financing small businesses must obtain to clean up their contaminated facilities.[183]

Potential environmental lender liability has created the same risk averse reaction in governmental and quasi-governmental agencies as it has in the private lending community. The Small Business Administration, the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the Farmers Home Administration, the Government National Mortgage Association, the Federal National Mortgage Association, and the Farm Credit Administration have all raised concerns regarding their potential liability under CERCLA and their interest in the promulgation of legislation to protect them from that liability.[184]

The lending community cannot ignore the potential liability it faces in the wake of judicial interpretations of lender liability under CERCLA that have made it vulnerable. As lenders continue to adapt their policies and practices to this new risk, small businesses are likely to experience even more difficulty.[185]

---

179. *Id.* at 139.

180. *Id.* at 141.

181. Such businesses include dry cleaners, transshippers, electric platers, wood product manufacturers, metal finishers, and other businesses that use hazardous materials in processing. *Id.*

182. *Id.*

183. The Petroleum Marketers Association of America testified that lenders' fear of incurring liability for hazardous waste cleanup is impeding efforts of petroleum wholesalers to obtain financing to repair and replace underground storage tanks to bring them into compliance with EPA regulations. *Id.*

184. *Id.* at 141-42; H.R. REP. NO. 1021, 101st Cong., 2d Sess. 17 (1991).

185. H.R. REP. NO. 1003 at 142.

2. Congressional Findings

In its report relating to the testimony at the hearings regarding the impact of judicial interpretations of lender liability under CERCLA,[186] Congress made several references to its intent in enacting CERCLA and, in some instances, how some courts have ignored congressional intent.

a. The Secured Creditor Exemption and Legislative Intent

The hearings established that Congress intended that the secured creditor exemption apply to a lender that exercises its rights under its security agreement by foreclosing upon and taking title to the collateral.[187] "The right of foreclosure, after all, is fundamental to secured credit. To construe otherwise is to state that Congress intended to create a right without a remedy."[188]

Congress criticized judicial decisions that, "despite the clear statutory language and intent,"[189] have held lenders liable "merely by virtue of the fact that they foreclosed"[190] upon contaminated property[191] but did not cause or contribute to the contamination or participate in the management of the borrower.[192] Congress identified *Fleet Factors*[193] as the "most disturbing case."[194] Under *Fleet Factors*' broad "capacity to influence" standard,[195] no secured lender is shielded from liability because any lender arguably has the capacity to influence its borrower's treatment of hazardous waste.[196]

While it criticized some courts for violating congressional intent in their search for deep pockets to pay for Superfund cleanups, Congress praised other courts for being "faithful to congressional intent and . . . respect[ing] the security interest exemption."[197] If its intent was not clear before, Congress

186. *Id.* at 141-42.

187. *Id.* at 140.

188. *Id.*

189. *Id.*

190. *Id.*

191. *See* Maryland Bank & Trust, 632 F. Supp. 573, 579-80 (D. Md. 1986).

192. H.R. REP. No. 1003 at 140.

193. 901 F.2d 1550 (11th Cir. 1990).

194. H.R. REP. No. 1003 at 140.

195. The court suggested that a secured creditor may be liable, without being an operator, if it participated in the management of a facility "to a degree indicating a capacity to influence the corporation's treatment of hazardous wastes." *Fleet Factors*, 901 F.2d at 1557.

196. H.R. REP. No. 1003 at 140.

197. *Id.* at 141 (discussing United States v. Mirabile, 15 Envtl. L. Rep. (Envtl. L.

plainly stated that it intended secured creditors to retain the protection of the secured creditor exemption while they hold the security interest[198] and after they foreclose pursuant to their security agreements.[199] Although it still has not clearly articulated the level at which a secured creditor's participation in the management of its borrower takes it outside of the protection of the exemption, Congress has expressly disapproved the *Fleet Factors* "capacity to influence" standard.[200]

b. The Innocent Landowner Defense and Legislative Intent

In creating the innocent landowner defense through the enactment of SARA, Congress intended to provide another basis for protection from liability under CERCLA for secured creditors and others.[201] Having heard the testimony at its hearings, Congress recognized that the defense provides no safe harbor from liability because the judicial and EPA interpretations of what the "all appropriate inquiries" test, for application of the defense, provide no guidance to lenders.[202] The testimony compared the search for an innocent landowner to Diogenes in the daylight with his lantern: if a lender's appropriate inquiry leads to a finding of contamination, the lender cannot be an innocent landowner; if the lender's inquiry finds no contamination, but contamination is discovered subsequent to the lender's acquisition of its interest in the property, then "all appropriate inquiry" was not made.[203] Thus, Congress plainly stated that lenders need more guidance as to what constitutes "all appropriate inquiry" for purposes of the innocent landowner defense.

3. Proposed EPA Rule Changes

The banking and environmental communities constantly seek clarification on all these issues from EPA[204] and Con-

Inst.) 20,994 (E.D. Pa. Sept. 4, 1985) and *In re* Bergsoe Metal Corp., 910 F.2d 668 (9th Cir. 1990)).

198. H.R. REP. NO. 1003 at 140.

199. *Id.*

200. *Id.*

201. *Id.* at 142.

202. *Id.*

203. *Id.*

204. EPA has issued several proposed drafts of a rule to help interpret the meaning of CERCLA. The latest proposal was distributed on January 24, 1991, to key government offices for review and comment. *Proposed Draft Rule*, *supra* note 131 at 1908.

gress.[205] EPA wants to maintain control of lender liability for Superfund cleanup sites as opposed to Congress taking legislative control. Therefore, EPA has issued a proposed rule to help interpret the meaning of the CERCLA provisions at issue, and adoption of the rule seems imminent.

a. The Security Interest Exception and Foreclosures

A lender must possess a valid security interest in order to avail itself of the secured creditor exemption. In the new proposal, EPA defines "security interest" to be "an interest that provides the security holder with recourse against real or personal property of the person pledging the security. The purpose of the interest is to secure the repayment of the money, the performance of a duty, or of some other obligation."[206] The security interest exemption only applies to security for a loan or other guaranty. Security interests do not include ownership interests for investment purposes.[207] This raises the issue of what is an appropriate length of time for a lender to dispose of foreclosed property and still maintain its security interest exception.

In response to confusion about foreclosure and time periods for divesture, EPA proposed a six-month grace period. The rule states:

> A foreclosing security holder who forecloses or otherwise acquires the property securing a loan or other obligation will lose the exemption if the security holder possesses or controls such property for an unreasonable length of time, in light of all such relevant facts and circumstances. Divesture of property within six months of foreclosure establishes a rebuttable presumption that the foreclosing security holder held the property for a reasonable length of time, and that its actions in taking possession and control of a vessel or facility were consistent with protecting the security interest. A security holder may continue to maintain possession or control of property for a period of time in excess of six months provided that the security holder demonstrates that it continues to hold the property primarily to protect its security interest, taking all relevant facts and circumstances into account.[208]

EPA believes the presumption in favor of the security

205. Representative LaFalce and Senator Garn have submitted bills to focus and narrow the scope of the lender liability exception.

206. *Proposed Draft Rule*, *supra* note 131, at 1913.

207. *Id.* at 1919.

208. *Id.* at 1920.

holder will provide additional certainty for lenders. Therefore, lenders will enter loan agreements freely and will not hesitate to foreclose when business judgment dictates that course of action. The general rule is that when a person or entity is entitled to a statutory exemption, that person or entity bears the burden of proof to show that it meets the qualifications for the exemption.[209] A presumption establishes that certain facts carry an evidentiary weight greater than other relevant evidence, such that the party in whose favor the presumption runs is better able to show that it is entitled to the exemption.[210] The benefit of the presumption is that, once the party claiming the presumption meets the initial burden of proof, the burden then shifts to the opposing side to show the lender does not fit within the security interest exception. One important element is that the rule does not create a counter presumption. When the lender is in possession of the property for longer than six months, the lender is not presumed to be acting outside the scope of the security interest. In that instance, the lender bears the burden of proof of showing that it was acting solely to protect its security interest and not in order to protect an investment.

b. Potential Problems

The six-month holding period may unfairly paralyze attempts to resolve problem loans, particularly in parts of the country suffering a severe real estate slump. Due to a depressed economy and the reduced value of contaminated property, a lender cannot dispose of the property and recover the funds invested.[211] Therefore, bankers feel this six-month time period does not adequately protect their security interest. As a consequence, smaller banks resist lending to gas stations, laundry establishments, paint manufacturers, and other businesses that are prone to charges of hazardous dumping.[212] This reluctance to loan money can even extend to properties close in proximity to contaminated properties, resulting from the fear that hazards would leak onto the neighboring property.

The EPA's standard of fair consideration may cause problems in parts of the country where fair market value for some pieces

209. *See* United States v. First City Nat'l Bank of Houston, 386 U.S. 361, 366 (1967).

210. *Proposed Draft Rule*, *supra* note 131, at 1912 (*citing* dicta from the EPA Rule).

211. Interview with Steve Nelson, President of First National Bank of Brewton, and President of Alabama Bankers Association (March 1991).

212. *Id.*

> of contaminated property may be zero or less than zero. Lenders saddled with property of minimal value in depressed markets may prefer to refuse $1 bids and hold onto the property in hopes the market will improve.[213]

Therefore, as critic Sharman Braff states, "a lender with contaminated collateral has only two choices: accept the cleanup costs and take the property for its net value; or abandon the collateral."[214] Braff suggests EPA could do more to protect the lender. When a lender takes possession of contaminated property, the lender must still dispose of hazardous wastes on the site. It is this removal of the waste that is viewed as involving the lender too deeply in the contamination process, thus resulting in the lender incurring liability. Furthermore, Braff suggests, EPA should allow lenders to sign the borrower's name to disposal activities so as not to transfer the responsibility onto the lenders.[215]

Another problem with the EPA rule is that the "revised draft continues to imply that lenders must satisfy duties not imposed by CERCLA — such as the duty to inspect a facility and the duty to consider and account for hazardous wastes in workouts."[216] EPA contends that in most cases, when a lender undertakes an environmental audit or inspection of property, it is considered to be acting in accordance with standard commercial practices and, therefore, in accordance with the purposes of CERCLA.[217] EPA claims that since the audit or inspection is an indicia of responsible behavior, the inspection can be raised as probative evidence that the lender's actions did not constitute participation in management.[218] It has been argued that EPA is offering lenders a "carrot of a presumption of nonliability after foreclosure."[219]

Another problem that arises is that only banks which can afford to make the environmental audits and play environmental watch dog can afford to take the risks involved in making loans to these business establishments.

---

213. *EPA Draft Says Creditors Using Standard Cleanup Practices Exempt from Liability*, 56 BNA Banking Rep. (BNA) 3 (Feb. 25, 1991) [hereinafter *EPA Draft*].

214. Sharman Braff, *The Lender as Environmental Policeman: Comment on EPA's Draft Lender Liability Rules*, 5 TOXICS L. REP. at 1429 (April 10, 1991).

215. *Id.* at 1430.

216. *EPA Draft*, *supra* note 213, at 5.

217. *Proposed Draft Rule*, *supra* note 131, at 1915.

218. Braff, *supra* note 214, at 1429.

219. *Id.*

> If bankers foreclose on property where hazardous substances have been disposed and they acquire the property with knowledge of such disposal, they are liable for response costs under section . . . [107](a)(1). If they have no knowledge of hazardous substances on the land, they will probably still be liable because of the duty of inquiry imposed on those acquiring property.[220]

Mitigative or preventive measures that are environmentally responsive are considered to be actions that preserve and protect the value of the facility. These types of measures protect the security interest. "The provision on foreclosures and liquidation requiring lenders to wind up operations is 'plain wrong' from a business standpoint because there are so many situations where it is more practical to sell an ongoing business than a defunct one."[221] According to EPA, "to remain within the exemption after foreclosure, the foreclosing entity must be acting to preserve the assets of the facility for its subsequent sale at the earliest possible time."[222] The goal, according to the EPA spokesman, "should be to interpret CERCLA to allow lenders to foreclose on property and to conduct loan workouts so they could protect their security interest without triggering CERCLA liability."[223] However, EPA further expects lenders to fulfill certain responsibilities: "First, EPA would expect lenders to act prudently with regard to making loans, including requiring investigations into the condition of the property and to ensure cleanups when appropriate. Second, upon learning of contamination, lenders may not exacerbate the contamination or jeopardize the public health or safety."[224]

C. *Participation in Management*

The "participation in management" threshold is an area in need of clarification. The EPA rule defines actions that are considered to be participating in management:

> actual participation in the management or operational affairs by the holder of the security interest, . . . does not include the mere unexercised capacity or ability to influence vessel or facil-

220. Steven B. Bass, Comment, *The Impact of the 1986 Superfund Amendments and Reauthorization Act on the Commercial Lending Industry: A Critical Assessment*, 41 U. MIAMI L. REV. 879 (Mar. 1987).

221. *EPA Draft*, *supra* note 213, at 6.

222. *Proposed Draft Rule*, *supra* note 131, at 1916.

223. *Id.*

224. *Id.* at 1917.

> ity operations. Whether the holder of the security interest has engaged in management participation depends upon all relevant facts, including but not limited to, the nature of the borrowers business, the areas in which the security holder becomes involved, whether the vessel or facility is in the possession of the borrower or the security holder (after foreclosure), the actual control exercised by the security holder over the borrower's activities, and whether the security holder has caused or contributed to environmental harm at the vessel or facility.[225]

A security holder is considered to be participating in management within the meaning of section 101(20)(A) if "while the borrower is still in possession, the security holder has materially divested the borrower of, or otherwise is engaged in, decision making control over the vessel or facility operations, particularly with respect to the hazardous substances present at the vessel of the facility."[226] Furthermore, any security holder "who causes or contributes to the release or threat of release of hazardous substances voids the exemption."[227]

The proposed EPA rule delineates certain activities that will not be considered to be "participating in the management" of a company. First, the lender may take precautionary measures at the inception of the loan or other transaction giving rise to a security interest. Such actions include environmental inspections and ongoing inspections to insure compliance with environmental standards. Second, the lender may police the security interest or loan. Policing the loan involves requiring the borrower to clean up the facility during or prior to the term of the loan as well as insuring that the borrower is in compliance with federal, state, and local environmental laws. Third, the lender may engage in loan work out proceedings. Loan work outs include restructuring or renegotiating of the terms of the loan, extending the payment period, or giving specific or general financial advice. The security holder must consider and account for the hazardous substances known to be present at the vessel or facility when providing such assistance.[228]

---

225. *Id.* at 1916.
226. *Id.*
227. *Id.*
228. *Id.* at 1920.

d. Potential Problems

One critic of the EPA rule charges that the rule puts lenders in a "catch 22" situation because "on the one hand, the lender must duly consider and account for hazardous substances and undertake actions consistent with CERCLA; but on the other, participation in the management of hazardous wastes is particularly likely to trigger CERCLA liability."[229] Duly accounting for environmental problems is contradictory to the requirement that the lender not participate in management of a company.

According to the commentators,

> Overall, the [EPA] rule . . . emphasizes that regardless of the lenders' actions, the borrower in possession must retain the ultimate authority. If the lender has "materially divested" the borrower of decisionmaking, particularly regarding hazardous substances, then the lender is participating in the management of the facility and is, therefore, outside the security interest exception.[230]

This capacity to control test is too broad and overreaching for lenders. Realistically, when the lender has a security interest in a company, it will, as a matter of course, have the capacity to control the affairs of the business once financial hardship occurs. The actual test of management should be whether the lender contributes to the day-to-day operations.

However, one EPA spokesman believes that the *Fleet Factors* and *Bergsoe* cases are consistent with the new EPA proposal.[231] Both the cases and the proposal contend that, before any liability can attach, there must be some degree of management by the lender. Even in *Fleet Factors*, the "secured creditor is liable as an owner only if the creditor exerts such controls so as to influence the facilities treatment of hazardous wastes."[232] It was not until Fleet actively handled the affairs prior to liquidation that the court saw fit to impose liability.

Many feel the interpretive rule issued by EPA does not nec-

---

229. Braff, *supra* note 214, at 1424.

230. George Wolf, *EPA's Lender Liability Rule: No Surprises But More Work Needed*, 21 Envtl. L. Rep. (Envtl. L. Inst.) 10,006 (1991).

231. John Fogerty is an attorney in the Office of Enforcement for Superfund in EPA. He served as the chairperson for the committee responsible for drafting the new EPA proposal.

232. *Environmental Issues Dominate Legal Decisions on Real Estate in 1990*, Business Wire (BNA) ¶ 19,115 (Jan. 4, 1991).

essarily provide lenders a "safe harbor." Despite the fact that the new EPA rule dispenses with most of the fears of *Fleet Factors*, the banking industry remains concerned that the rule does not go far enough to protect innocent lenders.[233] The rule addresses a lender's potential liability with respect to EPA rather than to other private parties. This can have significant implication in contribution actions and bankruptcy.[234] In theory, two different sets of rules could be applicable to lenders depending on who initiates the law suit. Although, the EPA policy "would provide guidance to enforcement attorneys at EPA and the Department of Justice, and might even cause the government to refrain from pursuing a secured creditor in certain cases, the policy would have no such effect upon state agencies or private parties."[235] The proposed rule may signal a change in EPA enforcement policy, but it will not prevent private parties in cost recovery actions from suing lenders.[236] Another concern is that the "statutory interpretation by the agency charged with implementing the law would be entitled to some judicial deference, it is only an interpretation of a liability standard and would not necessarily be binding upon any court."[237] Consequently, banking lobby groups feel that an "agency drafted interpretative rule cannot have the broad scope and impact that a statutory correction would have."[238] Also, since the Supreme Court denied review of *Fleet Factors*, no judicial remedy appears to be forthcoming. Consequently, bankers are pushing for Congress to take steps to statutorily correct the lender's dilemma.[239] In one instance, Representative John LaFalce introduced a bill designed to expand the security interest exclusion by exempting "any designated lending institutions which acquires ownership or control of the facility pursuant to the terms of a security interest held by the person in that facility."[240] Essentially, the bill would have amended CERCLA to exempt a foreclosing lender from CERCLA liability unless it

233. Interview with Steve Nelson, *supra* note 211.

234. Wolf, *supra* note 230, at 10,007.

235. *Id.*

236. *EPA Draft*, *supra* note 213, at 5.

237. David R. Berz & Peter M. Gillon, *Lender Liability Under CERCLA: In Search of a New Deep Pocket*, 108 BANKING L.J. 4 (Jan.-Feb. 1991).

238. Wolf, *supra* note 230, at 10,007.

239. *U.S. Supreme Court Declines Review of Case Involving Lender Liability under Superfund*, 10 Daily Rep. for Executives (BNA) A-1 (Jan. 15, 1991).

240. Berz & Gillon, *supra* note 237, at 7.

could be shown that the lender caused or contributed to the contamination.[241]

In another instance of congressional activity, Senator John Garn (R-UT) introduced a bill to amend the Federal Deposit Insurance Act and the Federal Credit Union Act as a means of exempting the Resolution Trust Corporation (RTC) and other federal banking agencies along with any depository institution or mortgage lender, from liability under CERCLA "with respect to property acquired through foreclosure: unless the foreclosing entity 'caused' the contamination."[242] The bill further provided that the foreclosing entity would be liable for the increased value of the property resulting from any cleanup.[243] The lender, however, would have had to implement adequate procedures to evaluate potential environmental risks on its collateral. If the lender had actual knowledge of the use of hazardous substances on the property, it too would have had to take all reasonable actions necessary to prevent the release of such substance.[244]

During hearings on the bills last summer, portions of the business community and environmentalists expressed concern that the bills would create too great a loophole for this special class of CERCLA potentially responsible parties.[245] Neither bill was passed in the 1990 session.[246] Recently, both LaFalce and Garn reintroduced their bills with some changes. LaFalce also acquired more than 120 cosponsors.[247] Opponents to the bills continue to feel it is not fair to relieve one class of potential parties from liability for the cleanup costs.[248] "We see no reason to give preferential treatment to banks and savings and loans in contrast to many other groups for which Superfund liability also attaches."[249] They argue it is not fair to place that burden on the rest of the business community. If lenders do not take some of the burden for environmental cleanup, then who will? If lenders are totally exempt from liability, then the burden will ultimately

---

241. *Proposed Draft Rule*, *supra* note 131, at 1913.

242. Berz & Gillon, *supra* note 237, at 7.

243. *Id.*

244. *Id.*

245. Wolf, *supra* note 230, at 10,007.

246. *Proposed Draft Rule*, *supra* note 131, at 1913.

247. *Id.*

248. Letter from the Chemical Manufacturers Association lobby group to Senator Howell Heflin (D-Alabama) (Oct. 24, 1990) (on file with author) (opposing amending Superfund legislation).

249. *Id.*

fall on the taxpayers. Another alternative would be for banks to require environmental audits and insurance before making loans. If this happens, the banks will not be responsible for the cleanup, instead the insurance policy will cover the costs.[250] Our society is already over-insured against financial disaster. Why should the area of hazardous waste liability be any different?

The new draft rule states that "a lender's failure to perform an environmental inspection before making a loan does not mean an automatic loss of protected status under the statutory exemption for secured creditors."[251] Another concern prior to the rule was that banks would incur greater business costs while trying to protect themselves from Superfund liability. Precautions taken by lenders include environmental audits, soil samples, monitoring of land usage, and pre-acquisition investigation of the ownership and usage history of the property.[252] The new rule does not seem to remove these monetary and administrative burdens from banks. Some argue that these administrative costs cause an increase in the cost of capital, in effect stifling economic growth, and may lead to a recession.[253] However, a few studies show that CERCLA lending is only a small percentage of total lending.[254] Therefore, one could argue it is good public policy to have some administrative burdens imposed on polluting companies.

One key element to remember is that the EPA rule is just a proposal at this time. EPA sent the proposal to key government officers for their review and is currently receiving their comments. Hopefully, lenders will find guidance in this dilemma through the EPA rule as well as through statutory relief.

The EPA proposed rule strikes a fair balance between the interests of the lenders and that of EPA. Ideally, lenders would like to be shielded from CERCLA liability entirely. However, when the lender is involved in a company that is polluting the environment, EPA should have the authority to hold the lender responsible. Overall, lenders are better served if the rule is approved rather than if it is not. The rule provides enough of a sufficient basis to guide lenders through the lender liability maze.

---

250. *See supra* note 75 and accompanying text.

251. *Proposed Draft Rule*, *supra* note 131, at 1913.

252. *Id.*

253. *Proposed Draft Rule*, *supra* note 131, at 914; Interview with Steve Nelson, *supra* note 211.

254. *See supra* note 75 (only slightly more than .2 % of all are lenders).

IV. SUGGESTED CAUSE FOR CONGRESSIONAL ACTION

A. *Narrow Interpretation Favored*

Lenders could make a significant contribution toward the advancement of CERCLA's goals by assisting financially distressed borrowers with potential environmental liability. Lenders could perform a monitoring role for potential environmental liability in the same way they normally monitor borrowers' financial health during the term of a loan. For example, rather than declare default, a lender could examine a borrower's potential environmental liability and financial viability, and provide the funds the borrower needs to hire experts to work the problems out.[255] If, however, lenders cannot evaluate the risk they may incur in this situation lenders will not assist such borrowers and may even refuse to lend to them.[256] A narrow interpretation of management participation would encourage lenders to perform a monitoring role. Effective monitoring of environmental practices is a crucial factor in achieving CERCLA's goals. Lenders, insurance companies, and the federal government are the likely monitors of hazardous waste practices.[257] An effective monitor must have expertise and be able to spread risk.[258] Accordingly, of the three candidates proposed, lenders are best situated because they have the expertise to monitor the economic and environmental health of their borrowers and the ability to spread the risk of incurring liability for cleanup costs.[259]

Lenders are expert monitors because their business is to collect and evaluate information about a borrower's operations before deciding to lend, to monitor their investments, and to direct the borrower's activities in order to protect the collateral.[260] Lenders negotiate for these rights through covenants in loan agreements. For example, a lender can, through covenants, require a borrower to conduct environmental audits, submit cop-

---

255. *See* Tom, *supra* note 40, at 927.

256. *See supra* notes 176-182 and accompanying text.

257. *See* Tom, *supra* note 40, at 931-33.

258. *See id.* at 931.

259. *Id.* Lenders would be more effective monitors of environmental liability than insurance companies because lenders still must assume the risk of under-insured debtors. *Id.* at 933. Lenders are more effective monitors than the federal government because the Superfund budget is limited, EPA's monitoring capabilities are limited, and lenders have information advantages due to the close debtor-creditor relationship they have with borrowers. *Id.*

260. *See id.* at 931-32.

ies of notices of environmental law violations, and notify the lender of any change in operation of the facility that may have environmental impacts.[261] Thus, lenders can effectively oversee their borrower's operations. Lenders are also experts at spreading risks. They can assume the costs of monitoring through interest rates and transfer the costs of environmental audits to their borrowers.[262]

A narrow interpretation of participation in management under section 101(20)(A) would encourage lenders to monitor borrowers with waste sites.[263] Such an interpretation would allow lenders to engage in workouts with borrowers who have environmental problems and would prevent future environmental damage through the lender's monitoring activities. A broad construction of participation in management would undermine CERCLA's goal of preventing future environmental damage by deterring lenders not only from monitoring, but from lending to businesses with potential environmental liability.[264] Moreover, it is now clear that such a construction is neither supported by the language of the statute, which specifically provides for exemption in some circumstances, nor by congressional intent.[265]

Management participation under CERCLA should be interpreted in such a way as to encourage lenders to deter reckless disposal practices by their borrowers. To encourage lenders to monitor their borrowers' environmental activities, a high and predictable threshold of liability for lenders should be established.[266] A low threshold of liability would encourage lenders to force borrowers with environmental liability into bankruptcy rather than incur potential liability. Thus, the consequences of a low threshold of liability would benefit no one: the borrower cannot pay for the costs of cleaning up its waste site, the lender may not collect the full amount of the loan, and the environmental damage continues until the government can clean up the site.[267] A high threshold of liability for lenders would avoid these problems.

---

261. *Id.* at 932 n.38.

262. *Id.* at 932.

263. *Id.* at 938.

264. *See supra* notes 177-183 and accompanying text.

265. *See supra* notes 186-200 and accompanying text.

266. *See* Tom, *supra* note 40, at 931.

267. *Id.*

B. Using Existing Theories to Provide Guidance

To avoid the very kind of incongruous interpretations that new guidelines will attempt to resolve, Congress should promulgate new guidelines by referring to and incorporating existing lender liability standards. Of the various theories of lender liability discussed earlier, equitable subordination[268] and alter ego[269] are best suited to provide a standard for interpretation of management participation.[270] These doctrines have been applied consistently in cases distinguishing between a lender's legitimate management of a loan and excessive control of a borrower's activities.[271] Courts apply the doctrines of equitable subordination and alter ego only if they find that the lender exercised control that amounted to total domination of the borrower.[272]

An approach that analyzes the lender's cumulative conduct by focusing on the total control exercised is consistent with the congressional goal of encouraging private parties to avoid contamination and mitigate the effects of any contamination that does occur.[273] This approach is also consistent with current congressional efforts to provide a definition to management participation. One bill currently pending appears to adopt just such a cumulative approach by proposing to define management participation as "the actual, direct, and continual or recurrent exercise of managerial control . . . [that] materially divests the borrower, debtor, or obligor of such control."[274] Furthermore, a cumulative approach will provide courts with flexibility in analyzing the particular facts of each case. Because courts have consistently applied these commercial law standards of lender liability,[275] a cumulative approach will also provide lenders with the predictability they need to establish policies and procedures for managing loans to borrowers with potential environmental liability.

---

268. *See supra* notes 37-42 and accompanying text.

269. *See supra* notes 27-29 and accompanying text.

270. *See* Tom, *supra* note 40, at 934-43.

271. *Id.* at 934-35.

272. *Id.* at 935.

273. 131 CONG. REC. S12,031 (daily ed. Sept. 24, 1985) (statement of Sen. Evans) (major objective of CERCLA is to "provide an incentive to those who manage hazardous substances or are responsible for contaminated sites to avoid releases and to make the maximum effort to clean up or mitigate the effects of any such release"); *Id.* at S12,008 (statement of Sen. Dominici) (stating that "we must provide incentives for the Government and private parties to join together rather than litigate").

274. H.R. 1450, 102d Cong., 1st Sess. (1991).

275. *See* Tom, *supra* note 40, at 937.

Conclusion

There can be little argument that the lending community is in need of guidance as to what activities it may undertake without exposing itself to liability under CERCLA. Congress itself recognizes this need and has made a move to develop legislation to provide that guidance. Congress should undertake to develop legislation that will provide the necessary guidance. In developing standards of conduct under these guidelines, Congress should clearly state that management participation under the secured creditor exemption be narrowly construed so that lenders are encouraged to monitor their borrowers with potential environmental liability. Rather than develop a new standard that will be subject to the same inconsistent interpretation, Congress should look to standards already developed under existing lender liability theories, such as the control theories developed under the doctrines of alter ego and equitable subordination. In this manner, the guidance it provides will be clear and consistent. A high threshold of liability and clearly developed standards for lender conduct will provide the predictability in evaluating potential risk that lenders need, and will encourage lenders to monitor their borrowers' hazardous waste practices, work with troubled borrowers to maintain their financial viability, and extend financing for implementation of antipollution procedures and cleanup of contaminated sites.