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LENDER LIABILITY FOR ENVIRONMENTAL CLEAN-UP
— by Neil E. Harl*

Until enactment of the comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)¹ or Super Fund, lender liability for the clean-up of environmental damage to the lender's collateral was rarely discussed. That has not been the case in recent years.²

Language of CERCLA

Under CERCLA, if toxic materials are found on mortgaged property, or if violations occur, the costs of cleaning up the hazardous wastes can be assessed against the owner or operator of the real property involved.³ The statute imposes liability on an "owner or operator." As the statute states —

"...in the case of an on-shore facility or an offshore facility, any person owning or operating such facility..." can be held liable under the act.⁴ The statute then proceeds to limit the liability of lenders —

"Such term [owner or operator] 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."⁵

The issue of lender liability, not surprisingly, was soon litigated. In United States v. Mirabile,⁶ the court held that there was a material issue of fact of whether a bank's control of a borrower's operation was sufficient for the bank to be held liable under CERCLA.⁷ The following year, in United States v. Maryland Bank & Trust Co.,⁸ the court held that the foreclosure of property of a debtor that is contaminated with hazardous materials exposes the creditor to liability for clean-up of the site. The court reasoned that the security interest exception protected only those holding such rights at the time of the clean-up. Thus, the court concluded, after the bank foreclosed on the property and obtained title, the statutory protection was lost.⁹ The court granted partial summary judgment against the bank as a secured creditor.¹⁰

Both of these cases were decided by district courts.

The key decision, United States v. Fleet Factors Corp.,¹¹ was decided in 1990 by the Eleventh Circuit Court of Appeal. The court extended the reach of CERCLA as to lenders as "owners or operators" by stating that lenders could be liable if they —

"...participat[e] in the financial management of a facility to a degree indicating a capacity to influence the corporation's treatment of hazardous waste."¹²

¹ Language of CERCLA
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¹² Language of CERCLA

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The court pointed out that liability would not be imposed where the secured creditor monitored selected aspects of a debtor's business.¹³ The court also noted that a secured creditor could become involved in an occasional and discrete financial decision relating to the protection of its security interest without incurring liability.¹⁴

The court in United States v. Fleet Factors Corp.,¹⁵ believed that its approach would have three positive results — (1) potential mortgagees would be encouraged to institute proper waste disposal practices of potential borrowers; (2) lenders would be encouraged to monitor the hazardous waste policies of their debtors and insist on compliance with environmental standards as a precondition to continued financial support, and (3) once a lender's involvement becomes sufficiently broad to risk losing its exemption from CERCLA liability, there would be a strong inducement to institute proper waste disposal rather than ignoring the problem.

The uproar over the Fleet Factors decision¹⁶ led to efforts to amend the statute. The Environmental Protection Agency (EPA) responded with a revised lender liability rule that has been characterized as "...complex and lender friendly."¹⁷ The EPA rule defined "participating in the management of a facility" in terms substantially more restrictive¹⁸ than the court decision in Fleet Factors.¹⁹ The revised EPA regulation specified —

"Participation in the management of a facility means actual participation in the management or operational affairs of the vessel or facility by the holder, and does not include the mere capacity to influence, or the unexercised right to control facility operations."²⁰

The EPA rule then proceeded to state that a lender is participating in management while the borrower is in possession of the facility encumbered by the security interest only if the lender either —

"(i) Exercises decision making control over the borrower's environmental compliance, such that the [lender] has undertaken responsibility for the borrower's hazardous waste handling or disposal practices; or

"(ii) Exercises control at a level comparable to that of a manager of the borrower's enterprise such that the [lender] has assumed or manifested responsibility for the overall management of the enterprise encompassing the day-to-day decision making of the enterprise...."²¹

The EPA rule also provided guidance on potential liability in conjunction with a foreclosure —

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"Indicia of ownership that are held primarily to protect a security interest include legal or equitable title acquired through or incident to foreclosure and its equivalents."22

The rule then pointed out that —

"The indicia of ownership held after foreclosure continue to be maintained primarily as protection for a security interest provided that the holder undertakes to sell, re-lease the property...or otherwise divest itself of the property in a reasonably expeditious manner...."23

Neither CERCLA nor the EPA rule require a prospective mortgagee to conduct an environmental audit at the site to qualify for the "lender exemption." Thus it is clear that —

• A lender remains within the exemption during the term of the security interest even though action is taken to police the loan.

• The exemption can be maintained even in the event of foreclosure provided the lender undertakes to sell or otherwise divest itself of the property in a reasonably expeditious manner using normal commercial means provided the mortgagee did not participate in management prior to the foreclosure.

• Following foreclosure, while the mortgagee is holding the property for disposition, the lender may liquidate, maintain business activities, wind up operations or perform environmental clean-up operations.

EPA rule held invalid

In a major development in 1994, much to the surprise of lenders, the EPA rule was invalidated in Kelley v. EPA.24

The U.S. Supreme Court refused to review the Kelley case in January of 1995. The lending community responded with renewed efforts to lobby for Congressional relief.25 The lender liability provisions of that legislation would have differed from the EPA rule in two major respects — (1) lenders would be required to perform pre-loan due diligence as a precondition to receiving favored treatment, and (2) qualifying lenders would still be liable for the net gains realized, if any, as a result of clean-up activities by EPA. The legislation did not pass in 1994. Legislation has been introduced in 1995 and is pending in the 104th Congress.26 That legislation would adopt many of the provisions in the EPA rule statutorily.

FOOTNOTES

5 Id.
7 Id.
9 Id.
10 Id.
12 901 F.2d 1550, 1557 (emphasis added).
13 901 F.2d 1550, 1558.
14 Id.
15 Note 11 supra.
16 Note 11 supra.
17 24 Env. L. 1045, 1046 (1994).
18 40 C.F.R. § 300.1100(c)(1) (1994).
19 See note 11 supra.
20 40 C.F.R. § 300.1100(c)(1) (1994).
21 Id.
23 Id.
24 15 F.3d 1100, 1108 (D.C. Cir. 1994).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS

AVOIDABLE LIENS. The debtors were livestock and grain farmers who filed for Chapter 7 bankruptcy. The debtors claimed exemptions in all farm equipment, livestock and farm produce under Minn. Stat. § 550.37(5) and sought to avoid the security interest in the machinery and livestock under Section 522(f)(2)(B) as impairing the debtors’ exemption for those assets. The trustee objected to the exemptions and avoidance of the security interest, arguing that the trustee had the power to avoid the security interest as unperfected; therefore, the debtors could not claim an exemption for the property claimed by the trustee. The court held that because the debtors sought avoidance first, the trustee was barred from attempting to avoid the security interest. The court held that Section 522(f)(2)(B) did not apply to livestock or crops not used for the personal benefit of the debtors; therefore, the security interest could not be avoided as to those assets but could only be avoided as to the debtors’ tools of the trade which included a long list of assets from a tractor to livestock huts. In re Flitter, 181 B.R. 938 (Bankr. D. Minn. 1995).

The debtors claimed an exemption in a residence which was subject to a mortgage and a judicial lien in excess of the fair market value of the property. The debtors sought to avoid the judicial lien and the issue was whether the entire lien was avoidable or whether the lien was avoidable only to the extent of the debtors’ exemption amount. The case was filed after the effective date of the 1994 amendment to Section 522(f) and the court held that the amendment codified the holding of In re Brantz, 106 B.R. 62 (Bankr. E.D. Pa. 1989) which held that the lien was avoidable only to the extent the lien impaired the exemption. In re Thomsen, 181 B.R. 1013 (Bankr. M.D. Ga. 1995).

CHAPTER 12-ALM § 13.03[8].*