Community Banking
NEWS

MURTHA CULLINA

PROTECTING LENDERS FROM LIABILITY UNDER ENVIRONMENTAL LAWS

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If you have questions about the issues addressed in this newsletter, or any other matters involving Community Banking issues, please feel free to contact any of our attorneys listed in this Alert.

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Environmental laws and regulations enacted at both the state and federal levels pose significant risks to and obligations on financial institutions. Laws imposing liability on "owners and operators" of contaminated property may result in direct claims against unwary lenders and fiduciaries, particularly if the institutions do not operate within "safe harbors" created by law. In addition, those laws, as well as others closely regulating the management and discharge of polluting substances, also affect the credit-worthiness of borrowers, their ability to meet financial obligations and the value of their collateral.

In this article, we will review the environmental laws impacting the operation of financial institutions and suggest ways those institutions can protect themselves.

I. DIRECT LIABILITY OF LENDERS AND FIDUCIARIES

A. Lender Liability

In the 1970s and 1980s, federal and state governments significantly expanded the scope and nature of liability for investigating and cleaning up contaminated property. The federal statute (The Comprehensive and Environmental Response, Compensation and Liability Act, "CERCLA" or "Superfund") and its state analogs impose liability for investigating and cleaning up property on past and present "owners and operators" of contaminated property. Investigation and cleanup, which must be conducted under detailed government supervision and meet increasingly stringent standards, often cost millions of dollars, take years to complete and prevent full use of the property on a temporary or even permanent basis.

In 1990, in a case that rocked the banking industry, a federal court held that the definition of "owner and operator" in CERCLA included a financial institution with the "capacity to influence" the actions of its borrowers. The Fleet Factors case held that a financial institution may be directly liable for environmental costs beyond the value of its investment and of its collateral. Many observers were distressed even further because common and long-held industry practices were considered to be "the capacity to influence," triggering liability.

The Fleet Factors case prompted several efforts to define an appropriate role for lenders and to protect them from liability. In 1996, Congress enacted via statute the United States Environmental Protection Agency's Lender Liability Rule (U.S.C.A. 42 § 9601(20)(3)), a regulation which had been held up on procedural grounds. The 1996 Act, adopted almost verbatim by Connecticut in 1998 (Connecticut General Statutes § 22a-452f), describes specific "safe harbor" practices lenders can undertake in making and monitoring loans, in anticipation of foreclosure, during foreclosure and after acquiring property through foreclosure. In general, the rule provides that "owners and operators" (i.e.,

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liable parties) do not include lenders that hold "indicia of ownership" primarily to protect a security interest.

The law defines "not participating in management" by listing specific "safe harbor" activities that may be undertaken without risking liability. These include:

1. monitoring and enforcing the terms of a security interest;
2. inspections;
3. requiring or performing response actions required by law;
4. providing financial advice to protect the value of the security interest; and
5. post-foreclosure attempts to sell or lease the property under commercially reasonable terms.

On the other hand, certain actions are defined as constituting "participation in management" which would give rise to liability. These include:

1. exercising decision-making authority over environmental compliance issues; and
2. exercising control at a level comparable to that of a manager in charge of general operational activities.

B. Fiduciary Liability

Fiduciaries may also be considered "owners or operators" liable for investigation and cleanup costs. Federal and state laws have established safe harbor provisions whereby trustees, executors, administrators and other fiduciaries may avoid being held personally liable under environmental laws. It is important to remember that trust assets may be used to meet environmental obligations even if fiduciaries operate within the safe harbors.

The CERCLA rules (42 U.S.C. 9607(n)) and similar provisions subsequently adopted by the State of Connecticut (Connecticut General Statutes § 22a-452d) allow fiduciaries to conduct the following activities without risk of liability:

1. undertake investigation and cleanup of contaminated property.
2. comply with environmental laws;
3. inspect and monitor environmental conditions;
4. provide financial advice to beneficiaries;
5. alter the terms of the fiduciary relationship; and
6. decline to take any of the activities described above.

It is also important to remember that the safe harbors will not apply if:

1. the fiduciary acts negligently in managing polluting substances;
2. the fiduciary is operating a for-profit trust, unless the trust was created to facilitate one or more estate plans or due to the incapacity of a minor; and
3. the fiduciary acquires ownership or control with the objective purpose of avoiding liability for itself or a third party.

Similarly, Connecticut's Fiduciary Powers Act (Connecticut General Statutes § 45a-234, §§ 7 and 39) specifically authorizes fiduciaries to inspect properties before accepting them into the estate, and to "take any reasonable action and expend any reasonable amount from the estate or trust" to comply with environmental laws.

II. PROTECTING THE COLLATERAL AND CREDIT-WORTHINESS OF BORROWERS

The application of environmental laws described above to "owners and operators" may also have a significant impact on the credit-worthiness of those borrowing money to acquire property, their ability to repay loans, and the value of their collateral. Simply put, money spent on investigating and cleaning up property is not available to repay loans. Further, the presence of contamination on property acts as an "encumbrance" of sorts on the property, reducing its value. Lenders may find that the collateral that they accepted has little value, or even negative value, due to environmental conditions. State and federal laws provide for a lien on property to cover costs expended by the government in cleaning up property. In Connecticut, that lien may take priority over all existing encumbrances (Connecticut General Statutes § 22a-452, the so-called "Super-lien" statute).

Institutions making loans to manufacturing businesses should also be familiar with and assess the impact of those environmental laws limiting the type and amount of pollutants that can be emitted into the air (Clean Air Act) and water (Clean Water Act) from ongoing manufacturing operations. Other laws establish strict handling requirements for hazardous waste (RCRA) and the operation of underground storage tanks. Significant capital and operating expenses are necessary to comply with these complex requirements, and failure to comply can result in civil penalties of up to $75,000 per day. In some cases, agencies can order facilities to shut down until full compliance is demonstrated.

III. SPECIAL STATE LAW ISSUES

A. The Connecticut Transfer Act (Connecticut General Statutes § 22a-134 et seq.

The Connecticut Transfer Act requires that when certain types of properties are conveyed, a party to the transaction or a guarantor must agree to investigate and remediate the property in accordance with standards developed by the DEP. Work is considered complete only if the DEP or a private Licensed Environmental Professional ("LEP") certifies that all relevant standards have been met.

Banks need to be aware of the applicability of the Transfer Act to transactions because investigation and remediation is required to be performed, and those activities may have an impact on the borrower's cash flow and its use of the property. Investigation and remediation activities may take years to complete, and depending on the extent of those activities, may render the property unusable for extended periods of time.

The Transfer Act applies to "transfers" of "establishments." "Establishments" are defined to include any real property or any business operation at which:

1. more than 100 kilograms (approximately one-half of a 55-gallon drum) of hazardous waste was generated in any one month;
2. a property or business at which hazardous waste generated at another location was managed or disposed of;
3. a dry cleaning facility;
4. a furniture-stripping operation; and
5. a vehicle body-repair facility.

While most conveyances of "establishments" are subject to the Transfer Act, there are a number of exclusions, including:

1. acquisition through foreclosure or conveyance of a deed in lieu of foreclosure;
2. conveyance of a security interest;
3. execution, assignment or termination of a lease for a period of a term for less than 99 years;
4. any change in ownership approved by a probate court, or pursuant to the terms of most wills or trusts; and
5. transfer of most residential properties, including condos.

B. The Connecticut Remediation Standards Regulations

In Connecticut, most sites, including those subject to the Transfer Act, must be remediated in accordance with standards developed by the DEP. The Remediation Standards Regulations, or "RSRs," include allowable numeric criteria for concentrations of dozens of contaminants in soil, groundwater, surface water and volatile gases emitted from soil and groundwater. The specific numeric criteria that will apply to properties will vary depending on the current and future use of the property. Furthermore, in some cases, more stringent cleanup requirements can be avoided by agreeing to limit the future use of the property through Environmental Land Use Restrictions (ELURs). Common ELURs include prohibitions on:

1. the use of on-site groundwater for drinking;
2. the use of the property for residential purposes; and
3. disturbance of "engineer controls" such as building slabs or paved areas.

For lending institutions, restrictions on the future use of the property may limit the value of the property and its ability to produce income over time. Lenders are more directly brought into the ELUR process by the statutory requirement that interest holders be required to subordinate their interest to the ELUR. At the very least, lenders should be aware of the need to subordinate and to account for that possibility in making and documenting loans.

IV. PROTECTING LENDERS – SOME PRACTICAL SUGGESTIONS

The key to avoiding direct liability, assuring the creditworthiness of borrowers, and properly valuating collateral is the timely receipt of pertinent information. While the type of information will vary depending on the nature of the property and the transaction contemplated, the information should be reviewed as early as possible so that the institution can make informed decisions.

There are two general types of environmental reports which provide the necessary information for banks to make informed decisions.

A. Environmental Site Assessments.

Environmental site assessments are designed to identify the presence of contamination on property and to estimate the extent of remediation necessary to comply with applicable remediation standards. Environmental site assessments are generally done in phases, and

may be performed by Licensed Environmental Professionals.

1. Phase I. The Phase I environmental site assessment is designed to identify whether there are potential sources of contamination on the property. This is achieved through a review of federal, state and local records and a site visit. Phase I environmental site assessments generally do not involve soil or groundwater samples. A Phase I environmental site assessment should also identify whether or not the property is an "establishment" subject to the Connecticut Transfer Act.

2. Phase II. The purpose of a Phase II environmental site assessment is to confirm the presence or absence of contamination. In Phase II reports, potential sources of contamination identified in the Phase I report (underground storage tanks, hazardous waste storage areas, drywells or floor drains, etc.) are sampled to determine if contamination is present. If contamination is present, a Phase III investigation will usually follow.

3. Phase III. A Phase III investigation is designed to determine the extent of the contamination and to identify potential remediation strategies. At this point, it may be possible to estimate the type and cost of the remediation required and if Environmental Land Use Restrictions can be used.

B. Compliance Audits

A compliance audit is designed to determine the extent to which a facility's operations comply with applicable environmental laws. For instance, a compliance audit will identify water discharges and determine if all required permits have been obtained and operations are within established parameters. Compliance audits are particularly important for transactions involving an ongoing operation.

V. CONCLUSION

It is essential for banks to develop policies to assure that they receive necessary information in a timely manner. Banks should establish requirements for receipt of environmental site assessments and, if necessary, compliance audits before making a loan or accepting a property into an estate for which the institution is a fiduciary. In addition to identifying the transactions and properties for which due diligence is required, the key to protecting the institution is assuring its access to internal and external expertise. The timely review of critical information by professionals allows institutions to go forward with the proposed transaction. In considering whether to go forward, a bank should weigh the cost and timing of the cleanup, as well as any future restrictions on the use of the property.

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