

Environmental Contamination and the Rise of Lender Liability

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In recent years, financial institutions have in some instances been held liable for environmental contamination caused by their borrowers. The outcry that has followed involves the security interest exemption included in the 1986 Comprehensive Environmental Response, Compensation and Liability Act (CERCLA or, more commonly, "Superfund"), which was designed to protect passive lenders. Several court decisions have held extremely narrow interpretations of the exemption, enabling the government to pursue lenders as "deep pockets."

The basic issue in determining liability is whether a lender's degree of involvement with a borrower renders the lender an owner or operator, and not simply a supplier of financing. In the 1985 case of *U.S. v. Mirabile*, a federal district court in Pennsylvania found that a lender which had foreclosed and gained title to a contaminated property could be held liable if that institution had sufficiently participated in management and control of the facility prior to foreclosure.

Under a more narrow interpretation, a subsequent Maryland case found that a lender could be held liable not because it had participated in management of the facility, but because it had assumed title. The court held that by foreclosing on the site, the lender had allowed its security interest to ripen into an investment. Although the lender was not responsible for generating pollution, the court held the lender, as owner of the property, strictly liable for costs of the cleanup.

In the May 1990 *U.S. v. Fleet Factors*, the 11th district U.S. Court of Appeals held that a lender could be liable if it had the mere *capacity* to influence a firm's decisions concerning hazardous waste disposal. This ruling puts at risk a significant number of normal lending activities, notably those involving workouts.

In the August 1990 *Bergsoe Metal Corporation* case, a federal circuit court rendered a decision that conflicts with that of *Fleet Factors*. Although this more recent holding requires the lender to have

taken certain actions in order to be liable, the *Bergsoe* court, like other courts in previous decisions, failed to identify what those actions might be.

Consequently, the courts have clouded the issue of whether lenders should foreclose on contaminated sites. Since cleanup costs may exceed property value, a bank might refuse to foreclose in order to avoid potential liability. Moreover, protective warranties and indemnities, which have become common loan features, are only as strong as the mortgagors' creditworthiness. In the event of foreclosure, courts will look to the actual borrower-lender relationship regardless of the presence of these clauses.

Economic Analysis

From an economic perspective, the lender liability issue focuses on whether the added imposition of liability on lenders is a more efficient allocation of productive resources than would be the limitation of liability only to polluting firms. Proponents of lender liability cite an argument that is somewhat compelling: the lender's independent risk analysis provides society with an added protection. Such reasoning, however, ignores agency costs incurred in the borrower-lender relationship. Placing responsibility for environmental compliance on lenders eliminates incentives for borrowers to carefully manage their own operations.

Liability should fall on those parties that can most easily remedy the offensive activities. Subjecting a lender to liability for actions taken by a borrower imposes on the economy the additional cost of the lender's monitoring action. A more efficient allocation of productive resources would be achieved if companies took full responsibility for their own compliance.

Because it increases the cost of foreclosure, lender liability reduces the supply of financing below the efficient level. This reduction, in turn, causes productive output to decline below the efficient level. Bankruptcies and unpaid debts increase, imposing the costs of liability onto third

parties. Furthermore, banks may be induced to shift potential liability costs to customers, through increased service charges or higher interest rates.

The market's long run responses may be counterproductive to CERCLA's original intent. Instead of merely discouraging institutions from lending to proven hazardous waste generators, the recent interpretations will dissuade lenders from providing funding to borrowers posing any potential environmental risks. Virtually all properties could present some risks of contamination. Yet even waste disposal facilities might in some cases be worthy of receiving funding; if there are fewer such facilities, the reduced competition among those remaining could cause the price of waste disposal and recycling to increase.

The Windfall Issue

It may be argued that preserving the security interest exemption would allow lenders to gain unjust enrichment from making loans to polluting facilities. The reasoning is that the lender, protected from liability, could acquire the property at the foreclosure sale for a bargain price, since other potential buyers would not be exempt from CERCLA liability. Following the cleanup (the costs of which would be borne by the government), the lender could sell the property, capturing the increase in the property's value.

However, it is not certain that this scenario would occur. The protected lender might be the only viable nongovernmental bidder at the foreclosure sale, but the most the lender could bid, without assuming liability as an investor, would be the outstanding loan balance (plus foreclosing costs). The EPA, with a lien of its own, could also bid; it could offer a price marginally higher than the lender's bid. Of course, because EPA's lien would be subordinate to the lender's, the sale proceeds would pay the outstanding loan balance. But EPA could then conduct the cleanup and sell the property; it would retain the difference between the property's

value after the cleanup and the balance on the loan. The Agency would limit its losses if it could be convinced to act in such an entrepreneurial manner.

Recent Developments

In response to what many view as gross unfairness in the *Fleet Factors* decision, there has been tremendous support for the restoration of the security interest exemption. Bills currently under consideration in Congress would protect the lender from liability unless the lender had caused the contamination. Surprisingly, in August of 1990, EPA announced that it would not oppose these bills; however, it would prefer to restore the exemption

lacking precision, the regulations state that the exemption does not apply to lenders that participate actively in management. Problems with these vague limitations arise because contemporary loan transactions frequently entitle lenders to various equity interests. These arrangements provide lenders with ownership in borrower facilities, or with shares of appreciated value or of profits earned on properties; they allow lenders to exercise certain controls over borrowers. Equity kickers may therefore render banks liable as owners if the arrangements allow banks to exert control over company operations or to gain additional profits from the success of polluting facilities.

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through regulation. The regulations have been drafted and are undergoing executive review at this time.

Drafts of the regulations reveal EPA's view that the exemption is designed to protect security interests, not investments. The distinction between a security interest and an investment, however, remains vague. EPA concedes that lenders must conduct some oversight to protect their security interests; periodic monitoring is acceptable as long as the borrower retains primary control of the facility. Workout financing, which typically includes alteration of the terms of the loan, counseling, or other reasonable actions which may help to avoid foreclosure, is also acceptable under the proposed regulations. It is interesting that these regulations protect entities such as the FDIC and RTC, which assume ownership of property through involuntary acquisitions or legal proceedings.

Reversing the government's stand in *Fleet Factors*, the regulations maintain that the lender's mere ability to exercise control of the polluting facility is not sufficient to trigger liability if the lender does not take affirmative actions. Still

Furthermore, to prevent lenders from gaining windfall profits, the regulations permit lenders neither to bid above outstanding loan balances nor to refuse reasonable bids from other parties. Finally, if a lender holds a property for longer than six months, it bears the burden of proving that its efforts are merely to protect the security interest.

The EPA realizes that the security interest exemption has been so ineffective that normal lending activity has been constrained. It hopes that the regulations will protect passive lending without unfairly benefiting the lenders or permitting them to offer unduly favorable terms to polluting borrowers. Although the new regulations may help courts interpret when lenders should bear liability, the ambiguity regarding equity participations and reasonable foreclosure terms will prove to be problematic in application.

Lenders have been charged with the responsibility and cost of policing their borrowers. Efforts to relieve these burdens are under way, but the ability of lending institutions to operate efficiently under the specter of CERCLA liability remains highly uncertain. ■

Cammack Lecture Series

An innovative educational tool has allowed students at the University of Illinois to learn practical aspects of the financial marketplace without leaving the classroom. Each Friday, students enrolled in the introductory insurance class, Finance 260, are addressed by leaders from the insurance industry through the *Emerson Cammack Lecture Series*. Because the topics covered include property insurance and risk management, the series is of interest to students in real estate and other areas of Finance as well as those studying insurance.

Among the topics that have been addressed are the problems facing property/casualty and life insurers, actuarial issues, consumer concerns, marketing developments, and career opportunities. Many notable insurance company executives have participated in the series, including Edward Rust, Chairman of the Board of State Farm; Raymond Kiefer, President of Allstate; Howard Humphrey, Chairman of the Board of Franklin Life; and James Skelton, President of the Illinois Insurance Exchange.

The lectures honor T. Emerson Cammack, who retired from the U of I this past August. Cammack, a noted authority on insurance, taught the University's introductory insurance course for 41 years. He also co-authored an acclaimed insurance textbook and served for 22 years as the Associate Dean of Undergraduate Affairs for the College of Commerce.

Professor Stephen D'Arcy coordinates the lecture series.

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