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# HOW TO ENVIRONMENTALLY ASSESS YOUR LOAN DOCUMENTATION AFTER FLEET FACTORS

AIMEE L. MANOCCHIO NASON *

## I. Introduction

Lending today is not so different from lending before December 11, 1980, when the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA),[1] became effective in the United States. Today, as in those pre-CERCLA days, a lender is expected to look into the future and predict the success of a borrower. The lender analyzes the borrower's financial condition and balances various risk factors against expected compensation from interest rates and fees and protection from the collateral and loan documentation. The lender then makes a credit judgment whether or not to make the loan. The difference, however, is that today a lender must also deal with what some perceive as the spectre of unlimited liability for the cost of cleaning up environmental contamination.

Yet, the fear of unlimited environmental liability exposure need not contaminate a loan proposal. Environmental data about the borrower's business and property can be compiled and analyzed. The lender can then factor into the lending equation the borrower's environmental health and compliance program as well as the cost of any suspected cleanup. Once the decision is made to lend, the lender can use the loan documentation as a vehicle for minimizing the lender's exposure for the environmental risks disclosed.

The loan documents should establish the environmental rights and liabilities of the parties. In particular, the borrower should be obligated to operate his business and maintain his property in compliance with state and federal environmental laws, to cleanup any release of hazardous substances and to indemnify the lender against any claims, costs or damages arising out of such a release. The lender should have the right to enter the borrower's property, to conduct environmental assessments and testing, to monitor the borrower's environmental compliance and to require the cleanup of any release or the correction of any violation. These rights assist the lender in determining the value of the property offered to secure the loan and in monitoring that value during the loan term. But, recent cases such as *United States v. Fleet Factors*,[2] have caused the lending community great concern that a lender's exercise of such rights might be characterized as "participation in management" or "control", thus causing the lender to lose the secured creditor exemption under CERCLA and exposing it to potential unlimited liability for cleanup costs.

The purpose of this article is to highlight some of the environmental provisions that should

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1. 42 U.S.C. §§ 9601-9675 (1988 & Supp. III 1991).

2. 901 F.2d 1550 (11th Cir. 1990), *cert. den.*, 111 S. Ct. 752 (1991).

be placed in the commitment letter and the loan documents in light of recent changes in environmental law. This discussion is not intended to be exhaustive. This article will also analyze the effect on loan documentation of the Environmental Protection Agency's (EPA) Rule on Lender Liability under CERCLA, published on April 24, 1992 (EPA Rule).[3]

## II. Definitions

The commitment letter and loan documents should contain definitions of key terms such as "hazardous substances," "release" of hazardous substances, "damages," "environmental requirements" and "notice," among others. The definitions should encompass all relevant state and federal laws, but should be broadly stated with a "catch-all provision" to catch any law or regulation that might otherwise be overlooked. The definitions also should incorporate prospective changes in the law. The environmental terms used in this article are defined in Appendix "A."

## III. Transaction Screening

There is an emerging trend among lenders to subject property offered as security for loans to a "transaction screening" process, which is designed to allow lenders to make an in-house determination of potential environmental risks, and to set the level of inquiry into the environmental condition of the property. Depending upon the result of this inquiry, environmental consultants may be called in to conduct in-depth assessments or to address specific issues. The information obtained in the screening process should be used in the underwriting analysis as well as the documentation of the loan.

In the pre-commitment stage, a lender should make a preliminary assessment of the environmental health of the borrower's business and the property being offered as collateral. This evaluation may be done by asking the borrower questions about the type of business to be or being operated on the property, the Standard Industrial Classification (SIC) number for the business, the prior uses of the property, the prior and present uses of adjacent property, the existence of underground tanks and above-ground tanks, and the existence of any notices of violation. Based upon the information provided, the lender may choose to walk away from the deal or to go forward to the commitment phase where a more in-depth assessment will be performed.

## IV. The Commitment Letter

The commitment letter for a real estate loan should state the lender's environmental requirements for the commitment process as well as the loan term. The lender's commitment to make the loan should be contingent upon the lender receiving a satisfactory environmental assessment of the collateral. The commitment letter should further state that the lender will determine the level of assessment to be performed and reserves the right to require additional testing or sampling as the lender deems appropriate. The cost of all environmental assessments including any additional testing or sampling should be borne by the borrower.

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3. 40 C.F.R. § 300.1100 (1992).

*A. Environmental Assessment*

A sample commitment provision requiring an environmental assessment is set forth below:

(i) This commitment is contingent upon the lender receiving a satisfactory environmental assessment of the property to be mortgaged. The lender, in its sole discretion, shall determine the level and scope of assessment and may change the level or expand the scope of assessment, as it deems necessary.

(ii) The environmental assessment may include, but not be limited to, a questionnaire completed by the borrower, a site inspection by an authorized representative of the lender or an approved environmental consultant, a Phase I site assessment[4] by an approved environmental consultant and/or such additional testing and sampling as the lender shall require, in its sole discretion. Only environmental consultants or engineers who are approved by the lender may be used for such assessments.

(iii) The lender also shall have the right to inspect and copy the borrower's books and records relating to environmental matters. The lender may interview borrower's employees, agents, consultants and experts relating to environmental matters. The borrower shall cooperate in furnishing the lender with such other information as the lender shall reasonably request.

(iv) The borrower shall be responsible for all expenses incurred in performing the environmental assessment, including but not limited to, consultant's fees and attorneys' fees, regardless of whether the loan is made.

*B. Condition of Property*

Generally, the commitment letter should require the borrower to demonstrate that its use of the property complies with all federal, state and local environmental laws. If the borrower's business involves the handling, storage or disposal of hazardous substances, the borrower

4. The purpose of a Phase I environmental assessment or audit is to identify potential environmental concerns. It is a limited investigation of "the environmental characteristics of a property" or facility by an environmental professional. *Environmental Assessments*, Environmental Due Diligence Guide (BNA) § 111.5 at 111:17 (1992). Although the term "Phase I" is commonly used in the lending, consulting and legal communities, there is no true consensus on what the scope or content of a Phase I site assessment ought to be. *Id.*; Catherine M. Ward, *Environmental Risk Assessment*, BANKING L.J. 204, 211 (May-June 1993).

A Phase I site assessment typically involves four phases: (i) a records review to compile "all documented information concerning past uses of the property, liens placed on the property, and past and present violations on the property;" (2) a site inspection of the property with a view towards identifying "visually observable evidence of releases or threatened releases of hazardous substances, and visually ascertainable indications of the existence of underground storage tanks, hazardous waste storage facilities and asbestos;" (3) interviews with present owners, operators and local governmental officials to discover "undocumented information regarding the past history of the site;" and (4) evaluation of the environmental data and preparation of a report, which should include a description of the observations, interviews and data, copies of all reports obtained in the records review process, conclusions as to existence or likely existence of contamination based upon visual indicators and the records review, and recommendations regarding further testing. *Id.* at 212-13. Beware, though, of a Phase I report containing the conclusion that the property is "clean," because "[i]t is not technically or legally possible" to draw such a conclusion based upon the limited investigation involved in a Phase I site assessment. *Id.* at 213-14.

should provide the lender with evidence that the hazardous substances are and have been handled properly and that all required permits and licenses have been obtained and are being maintained. The borrower should also demonstrate that its environmental compliance measures are consistent with applicable environmental laws.

An example of such a provision would be as follows:

> As a condition of closing the loan, the borrower must furnish the lender, evidence, satisfactory to the lender and its counsel, that there are no hazardous substances, solid waste or waste on the property to be mortgaged. If there are hazardous substances, solid waste or waste on the property, the borrower shall provide the lender with satisfactory evidence that: (1) the borrower possesses all necessary permits and approvals for the activities conducted on and the substances stored or maintained on the property; (2) there has been no release of hazardous substances, solid waste or waste on the property, except pursuant to required permits; and (3) procedures have been established to prevent the release of such substances on the property, except in accordance with required permits. If a release has occurred, the borrower must demonstrate that it is in the process of cleaning up such release in accordance with applicable law and within a specified time frame.[5]

### *C. Underground Storage Tanks*

The commitment should also contain conditions regarding underground storage tanks. The borrower should demonstrate that any underground storage tanks on the property are properly registered and do not leak. For example:

> If underground storage tanks are present on the property, the borrower shall furnish the lender with copies of the current tank registration certificates. The borrower shall also furnish the lender with tests of the underground storage tanks including the related pipes, lines, fixtures and equipment conducted by an independent person or firm qualified to perform such underground tank services under applicable law. Such

5. If the property being mortgaged is located in New Jersey, lenders should be concerned with whether the property and/or the transaction is within the scope of the New Jersey Environmental Clean Up Responsibility Act. N.J. STAT. ANN. §§ 13:1K-6 to -14 (West 1991) (hereinafter "ECRA). The commitment letter should require the borrower to demonstrate exemption from or compliance with the requirements of ECRA. If the mortgaged property is an "industrial establishment" as defined in ECRA, N.J. Stat. Ann. § 13:1K-8(f), and the transaction involves the sale, transfer or closure of that facility as defined in N.J. Stat. Ann. § 13:1K-9, the borrower should be required to produce a negative declaration approved by the New Jersey Department of Environmental Protection and Energy (hereinafter "NJDEPE), or a final approval of cleanup from that agency. If the property is not an industrial establishment or does not involve a sale, transfer, or closure which triggers ECRA, a letter of non-applicability may be obtained from the NJDEPE stating that ECRA does not apply. Lenders should keep in mind, however, that a letter of non-applicability, in and of itself, *does not mean the property is clean*. It may merely mean that the business operated on the property does not have a Standard Industrial Classification number which is covered by ECRA or the transaction does not trigger ECRA.

It should be noted that ECRA is about to be drastically amended by New Jersey Senate Bill 1070 which was reported from the Senate Subcommittee on March 15, 1993. Governor Jim Florio has indicated that he will approve the bill if it is adopted by both the Senate and the Assembly. The changes proposed by Senate Bill 1070 are too numerous to mention here. But, ECRA will be renamed the "Industrial Site Recovery Act."

> person or firm must certify to the lender whether the tanks and related pipes, lines, fixtures and equipment leak and that the tests were performed in a manner conforming to federal, state and local standards.

If the loan involves the replacement, expansion or modification of existing underground tanks or the installation of a new underground tank system, the borrower should provide the lender with copies of the necessary permits and evidence of compliance with applicable laws and regulations.

*D. Loan Documents*

In dealing with the loan documents, the commitment letter should state that the lender will have the right to enter and inspect the property, to evaluate the borrower's environmental compliance, to require testing and sampling, and to require the borrower and any guarantors to execute loan documents containing environmental representations, warranties, covenants and indemnification agreements. If the borrower's attorney is expected to opine on any environmental matters, that should be set forth as well.

*E. Termination of Commitment*

Finally, the commitment letter should state the specific circumstances under which the lender can terminate the commitment if the environmental assessment discloses contamination or noncompliance with environmental requirements. An example of such a provision is stated below:

> If the lender obtains information from the environmental assessment or any other source, which, in the lender's sole opinion, materially diminishes the value of the property to be mortgaged or the other collateral, the lender may immediately terminate this commitment and shall have no further obligation to consummate the proposed loan described in this commitment.

Where a particular environmental condition is suspected, the commitment letter may be tailored to cover that condition. For example, it may provide that if the property is discovered to be located near a landfill, Superfund site[6] or other environmental hazard, the lender has the option of terminating the commitment.

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6. A "Superfund site" is a site that the United States Environmental Protection Agency (EPA) has identified as containing hazardous substances and requiring remedial or response action under CERCLA. Susan M. Cooke, 2 THE LAW OF HAZARDOUS WASTE - MANAGEMENT, CLEANUP, LIABILITY, AND LITIGATION § 13.01[2] at 13-8 (1987). The EPA-ranked sites with the highest priority for cleanup are included on the National Priorities List (NPL) which appears as an appendix to the National Contingency Plan (NCP). *Id.* at § 13.01 [4][d] at 13-18.1, 13-20. *See* 40 C.F.R. § 300, App. B (1986). The NCP describes the EPA's procedures and standards for responding to releases of hazardous substances and other environmental emergencies. *Id.* at § 13.01[4][d].

## V. Environmental Documentation

All environmental provisions should be contained in a single document which may be called the "Environmental Agreement." Cross references may be made to the Environmental Agreement in the other loan documents, as appropriate. Environmental Agreement provisions which are repeated in other documents must be consistent. Otherwise, inconsistent provisions may lead a court to apply the well-settled rule that ambiguities must be construed against the drafter, which, in this case, would be the lender. A default under the Environmental Agreement should constitute a default under the other loan documents, thus permitting the lender to exercise all available rights and remedies.

## VI. Representations

Representations and warranties regarding the environmental condition of the borrower's property and business should be included in the Environmental Agreement. By making representations, the borrower commits to a certain state of facts or knowledge regarding the property at the time the loan is made. That state of facts may be used as a baseline for subsequent due diligence and on-going monitoring of the loan, provided that the lender has implemented internal procedures for such monitoring. The Environmental Agreement should provide that the borrower's representations and warranties are automatically reaffirmed, for example, when the borrower updates its environmental questionnaire or when a draw is made on a revolving line of credit. In this way, if the borrower misrepresents the condition of the property before or during the loan term, an event of default will occur and the lender may exercise all of its rights and remedies.[7]

Nonetheless, those rights and remedies may be of little comfort to the lender if the borrower is rendered insolvent by the cost of cleanup or compliance; or, if the lender finds the "collateral" is subject to the government's superlien and the lender's first mortgage is now second and subordinate to that superlien.[8] A lender who makes loans without an environmental

7. This is not to suggest that breach of an environmental representation or covenant alone may be sufficient for a lender to accelerate a loan. Generally, a payment default must have occurred before a loan may be accelerated. Otherwise, the lender may face exposure for lender liability upon the theory that it breached its duty to act in good faith by calling the loan when the prospect of repayment was not impaired. *See, e.g.*, Shaughnessy v. Mark Twain State Bank, 715 S.W. 2d 944, 950-54 (Mo. App. 1986). *Cf.* Centerre Bank of Kansas v. Distributors, Inc., 705 S.W. 2d 42, 47-48 (Mo. App. 1986) (holding that a lender's decision to call for payment on a demand note is not subject to a good faith requirement).

Nonetheless, cleanup of a serious hazardous waste spill or other environmental condition may involve substantial cost to the borrower thereby affecting its ability to repay the loan. If the borrower's breach of environmental covenants caused the environmental condition, the lender may be able to argue that the borrower's exposure for the cleanup costs, if substantial, provides a reasonable basis for the lender to believe that the prospect of repayment is seriously impaired and supports the lender's election to accelerate the loan on that basis.

8. *See* N.J. STAT. ANN. § 58:10-23.11f(f) (West 1991). Under the New Jersey Spill Compensation and Control Act, N.J. Stat. Ann. §§ 58:10-23.11f(c)-(e) (West 1992), the Spill Compensation Fund is liable for any cleanup and removal costs incurred by the NJDEPE in remediating a site. These expenditures are the debt of the person causing the contamination. Upon the proper filing of a notice of lien with the clerk of the New Jersey Superior Court, this debt becomes a lien which attaches "to the revenues and all real and personal property of the discharger, whether or not the discharger is insolvent." N.J. STAT. ANN. § 58:10-23.11f(f) (West 1992). The lien created on the remediated property, however, has "priority over all other claims or liens which are or have been filed against the property," and

assessment relies only upon the truth and accuracy of the borrower's representations. If the borrower does not disclose a hazardous spill or does not know of the spill, the lender risks the possibility of serious unforeseen environmental contamination and the incalculable financial exposure that may accompany it.

In the past, negotiation of environmental representations at the closing table may have been used as a tool for discovering the property's environmental condition. Today, prudent lending practice dictates the performance of some form of environmental assessment — a questionnaire, a site inspection or a Phase I environmental audit — before the money is passed across the table and ongoing monitoring of the condition of the property during the loan term.

*A. Use of Property*

Representations regarding the prior use of the property by the borrower and its predecessors are helpful in establishing the lender's due diligence in evaluating the environmental risks posed by the proposed project. Evidence of such due diligence is necessary to preserve some of the lender's defenses, such as the innocent landowner defense or third party defense under CERCLA.[9] Essentially, the lender may argue that the contamination was caused by a third party who was not an employee or agent of the lender and who was not in a contractual relationship with the lender, provided that the lender exercised due care with respect to the hazardous substances and took appropriate precautions against foreseeable acts or omissions by such third party and the foreseeable consequences therefor.[10] Furthermore, the lender must demonstrate that when it purchased the property, it did not know or have reason to know that any hazardous substances were disposed of on the property[11] and that it undertook "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice."[12]

Examples of representations regarding use are as follows:

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hence has earned the name "superlien." *Id.*

Examples of other state superlien statutes are: ARK. CODE ANN. §§ 8-7-417, 8-7-516; CONN. GEN. STAT. ANN. § 22a - 452a (1991); MASS. GEN LAWS ANN. Ch. 21E; NH REV. STAT. ANN. Ch. 147-B:10-b; and TENN. CODE ANN. § 68-46-209. This list is not intended to be exhaustive.

Under CERCLA, the EPA is granted a lien against any property on which it is required to take remedial action to deal with a threatened or actual release of hazardous substances. The lien arises at the later of the time the EPA incurs the cleanup costs or notifies the property owner of the potential liability. It will remain against the property until the liability for the cleanup costs and damages are satisfied or becomes unenforceable based upon the statute of limitations. 42 U.S.C. § 9607(l)(2) (1988). The CERCLA lien, however, is not a superlien. It has the same priority as a judgment lien entered against the owner of the real property. The lien is "subject to the rights of any purchaser, holder of a security interest, or judgment lien creditor whose interest is perfected under applicable State law before notice of the lien has been filed" in the state or county where the property is located. 42 U.S.C. § 9607(l)(1) (1988).

9. 42 U.S.C. § 9601(35)(A)-(C) (1988) (innocent landowner defense); 42 U.S.C. § 9607(b)(3) (1988) (third party defense).

10. 42 U.S.C. § 9607(b)(3).

11. 42 U.S.C. § 9601(35)(A)(i).

12. 42 U.S.C. § 9601(35)(B).

*1. Past and Present Use*

None of the borrower's real property, including but not limited to, the property being mortgaged to the lender (hereinafter collectively, the "real property), is now being used or has ever been used in the past by the borrower or any previous owner or operator, for activities involving hazardous substances, including, but not limited to, the use, generation, collection, storage, treatment, transportation or disposal of, hazardous substances.

*2. Treatment, Storage or Disposal of Solid Waste*

The borrower's real property is not being used nor has it ever been used in the past for a landfill, surface impoundment or other area for the treatment, storage or disposal of solid waste (including solid waste such as sludge).

*B. Compliance, Permits and Licenses*

Similarly, representations regarding compliance and the existence of permits and licenses should also be included in the Environmental Agreement.

*1. Compliance*

The borrower's real property is now, and will continue to be, in compliance with all applicable environmental requirements, whether or not those requirements concern the presence of hazardous substances, waste or solid waste.

*2. Permits, Licenses and Approvals*

The borrower has obtained and shall maintain during the loan term all federal, state and local permits, licenses and approvals required for the borrower to operate its business on the mortgaged property. A true and complete list of all such permits, licenses and approvals and copies thereof are attached as Schedule "A" and incorporated by reference.

*C. Investigation, Litigation and Liens*

The Environmental Agreement should also contain representations regarding whether the borrower or its property is the subject of any pending or threatened environmental litigation, administrative proceedings or investigations. The existence of any environmental liens against the mortgaged property or other properties held by the borrower as well as any lien that could affect the financial condition of the borrower should be disclosed. These representations assist the lender in assessing the value of the property being offered as collateral. If the borrower is facing substantial exposure for cleanup costs or the property is subject to a lien for cleanup funds which have already been expended, the property may be of little value as collateral for the loan.

Suggested representations are set forth below:

*1. No Liens*

To the best of the borrower's knowledge, after its due inquiry and investigation, no lien has been attached to any revenues or any real or personal property owned by the borrower and located in the State of [ ], including but not limited to the mortgaged property, as a result of any expenditures being made pursuant to any environmental protection law, or otherwise. If a lien shall be filed against any of borrower's property, borrower shall discharge and otherwise remove same within thirty (30) days after the lien is filed.

*2. No Notices*

The borrower has not been identified in any litigation, administrative proceeding, or investigation as a violator, responsible party or a "potentially responsible party" under any environmental requirements concerning any intentional or unintentional action or omission on the borrower's part resulting in a violation of any environmental protection law.

Environmental representations and warranties have been included in loan documentation for years. Now, though, the lender, through the environmental assessment process, may have more and better information at its disposal regarding the borrower and its property. That information should be used to tailor the environmental representations and warranties to fit the borrower's environmental profile and the transaction.

## VII. Covenants

Environmental covenants in the Environmental Agreement establish the borrower's affirmative obligations relating to environmental matters and proscribe certain conduct by the borrower. Typically, the borrower agrees to: (i) comply with all environmental requirements applicable to the property; (ii) maintain the environmental permits and licenses necessary for the operation of its business; (iii) notify the lender of any release of any hazardous substances; (iv) notify the lender of its receipt of any notices of violations or claims; and (v) clean up any release of hazardous substances or correct any violation of environmental requirements. The borrower also agrees not to (i) use, generate, collect, store, treat or dispose of hazardous substances on the property or adjacent properties; (ii) dispose of solid waste on the property or use it as a landfill; or (iii) cause, allow or permit others to do (i) or (ii) above. If the borrower breaches any covenant, the lender may declare a default under the loan documents and exercise its rights and remedies.[13]

*In all cases, the environmental covenants should be tailored to the specific environmental requirements applicable to the borrower. However, they should be stated broadly enough to prevent any activities or conduct from falling through the cracks.* A more detailed discussion

13. *See supra* note 5 (discussion of lender liability concerns upon acceleration of the loan for a non-payment default).

of suggested environmental covenants appears later in the discussion of the EPA's Rule on Lender Liability under CERCLA.

### VIII. Indemnities

Another way a lender may protect itself against unlimited exposure from environmental claims is through indemnification provisions. Under CERCLA, a lender may be held primarily liable for cleanup costs as an "owner" or "operator"[14] regardless of the borrower's solvency. An indemnification clause permits the lender to recover directly from the borrower the costs the lender incurs because of the borrower's violation of the environmental requirements. Any guarantors should be required to indemnify the lender against such costs as well. A sample indemnification provision is stated below:

> The borrower and guarantors agree to indemnify and hold harmless the lender, its successors and assigns from and against any and all loss or damage which may be imposed upon, asserted against or incurred by the lender, its successors or assigns, by any party (including without limitation a governmental entity) arising out of or in connection with any environmental conditions on the property which may require remedial action or result in liability to third parties, whenever they arise.
>
> The term "loss or damage" shall mean and include all losses, damages, liabilities, obligations, penalties, unpaid loan amounts, litigation expenses, disbursements, judgments and the like, including, but not limited to, reasonable attorney's fees, expert witness fees and other costs of litigation or administrative proceedings, including preparation therefor. It also shall specifically include: (i) the cost of removal of any and all hazardous substances from all or any portion of the property or surrounding areas; (ii) the additional costs required to take appropriate precautions to protect against the release of hazardous substances on, in, under or affecting the property into the air, any body of water and other public domain or surrounding areas; (iii) expenses incurred to comply with all applicable environmental laws in connection with the property and surrounding areas; and (iv) any matter arising out of or in connection with any conditions whether caused or created by the borrower or guarantors, and whether they existed before or after the loan closing.

### IX. Other Protective Provisions

Before turning to the effect of the EPA's Rule on loan documentation, a brief discussion of other protective provisions is appropriate. When lending to a "heavy industry" borrower, a lender should consider requiring the borrower to purchase environmental insurance for the loan term because the risk of environmental problems is much greater with such borrowers. The cost and availability of such insurance will vary.

The Environmental Agreement should contain a survival provision which states that the environmental representations, covenants and indemnities will survive the expiration or termination of the loan documents and the repayment of the loan.

Finally, in view of the large number of lender liability claims, a lender should consider

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14. 42 U.S.C. § 9607(a)(1) (1988).

using provisions that limit its exposure to such claims, for example, waiver of jury trial,[15] waiver of consequential damages,[16] and notice of claims requirements.[17] These provisions are not recommended for all transactions. They are most appropriate in large negotiated commercial loan transactions where the borrower is represented by counsel and has equality of bargaining power. Defensive provisions such as these are likely to be met with opposition from the borrower. So, they need not be deal-breakers. But, as more lenders begin to use them, they will become more accepted in the marketplace.[18]

## X. The Effect of EPA's Rule on Loan Documentation

CERCLA provides that an owner or operator of a facility is strictly liable for the cost of cleaning up any hazardous substances disposed of at the facility.[19] The Secured Creditor Exemption under CERCLA excludes from the definition of owner and operator "a person, who, without participating in the management of a . . . facility, holds indicia of ownership primarily to protect his security interest in the . . . facility."[20]

The Eleventh Circuit Court of Appeals in *United States v. Fleet Factors Corp.* held that a secured creditor may be liable under CERCLA, "without being an operator, by participating in the financial management of a facility to a degree indicating a *capacity to influence* the corporation's treatment of hazardous wastes."[21] The Court further held that a lender need not get involved in the day-to-day operations of a facility or participate in management decisions relating to the hazardous waste to be liable under CERCLA.[22] Instead, the Court concluded that "a secured creditor will be liable if its involvement with management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose."[23] The *Fleet Factors* decision sparked a debate in Congress, the courts, and the lending community over what activities constitute participation in management and what activities are consistent with the Secured Creditor Exemption. The EPA, in its recently released Final Rule on Lender Liability, has attempted to answer the questions raised by *Fleet*

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15. Maury B. Poscover and Julie L. Compton, *Avoidance Techniques: Update on Jury Waiver Provisions*, 3 LENDER LIAB. L. REP. No. 8, 5 (Feb. 1990).

16. Barkley Clark and Barbara Brewer Clark, *Defensive Loan Documentation: How, When and Why to Use Anti-Lender Liability Devices*, 4 SECURED LENDING ALERT No. 5, 1-2 (July 1988).

17. Maury B. Poscover, *Avoidance Techniques: Protective Clauses in Loan Documents - Drafting Suggestions*, 2 LENDER LIAB. L. REP. No. 1, 6 (July 1988).

18. Clark, *supra* note 16, at 3.

19. 42 U.S.C. § 9607(a)(1) (1988).

20. 42 U.S.C. § 9601(20)(A) (1988).

21. 901 F.2d 1550, 1557 (11th Cir. 1990) (emphasis added).

22. *Id.* at 1557-58.

23. *Id.* at 1558.

*Factors*. It is yet to be seen whether the EPA Rule will give lenders the certainty which they have been seeking.

In the loan documentation context, "participation in management" is the key element of the Secured Creditor Exemption. The *Fleet Factors* decision did not address the application of the exemption to loan documents directly.[24] But, its "capacity to influence test" opened the door for a court to find that various environmental, financial or other covenants commonly found in commercial loan documents have given the lender the ability to influence or control the borrower (even if the loan provisions had not been exercised), thus subjecting the lender to strict liability under CERCLA.

The EPA Rule flatly rejects the "Capacity to Influence" test set forth in *Fleet Factors*.

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24. Two cases which have considered "participation in management" arguments based upon loan provisions are United States v. Mirabile, 15 Envtl. L. Rep. (Envtl. L. Inst.) 20,992 (E.D. Pa. Sept. 4, 1985), and In re Bergsoe Metal Corp., 910 F.2d 668 (9th Cir. 1990). In *United States v. Mirabile*, three lenders loaned money to Turco Company (borrower) which operated a paint manufacturing facility. The lenders took various types of collateral to secure their loans. Subsequently, the borrower went into bankruptcy and the Mirabiles purchased the property on which the plant was located in foreclosure. The EPA cleaned up the property and sued the Mirabiles, as the owners, to recover the cleanup costs. The Mirabiles then joined the three lenders as third-party defendants. The Mirabiles argued that the Small Business Administration (SBA), which held a second mortgage on the property but did not foreclose upon it, participated in the borrower's management because of SBA regulations then in effect that required the SBA to provide management assistance to its borrowers, and certain provisions in the loan agreement. The court found that although the SBA Regulations required management assistance, there was no evidence that such assistance was given. It further found that the SBA loan agreement provisions which appeared to give the SBA the authority to participate in the borrower's day-to-day management were never exercised. Finally, the court concluded that certain covenants which restricted the borrower's financial dealings such as limitations on the payment of annual compensation for, the purchase of life insurance on, or the payment of dividends or advances to the borrower's operating officers, without the SBA's prior consent, merely constituted participation in the "purely financial aspects" of the borrower's operations. These restrictions merely limited the flow of cash to principals of the borrower and not to the cleanup of hazardous substances, as the Mirabiles argued.

*In re Bergsoe Metal Corp.* involved the issuance of industrial development bonds and pollution control revenue bonds by the Port of St. Helens to finance the acquisition of land and the construction of a lead recycling plant. 910 F.2d at 669. Shortly after it began operating the recycling plant, Bergsoe experienced financial difficulties. *Id.* at 670. As part of a workout arrangement, Bergsoe and United States National Bank of Oregon (Bank), the trustee for the bond issue, agreed to install an outside management company to operate the recycling plant. Unfortunately, the plant did not fare any better in the management company's hands. The Bank then forced Bergsoe into involuntary bankruptcy. When the Oregon Department of Environmental Protection determined that the property was "dirty," the issue became who would clean it up. *Id.*

In holding that the Port of St. Helens did not participate in the management of Bergsoe, the Ninth Circuit articulated a different standard from the Eleventh Circuit in *Fleet Factors*. *Id.* at 672. The court stated:

> What is critical is not what rights the Port had, but what it did. The CERCLA security interest exception uses the active "participating in management." Regardless of what rights the Port may have had, it cannot have participated in management if it never exercised them.

*Id.* at 672-73.

The court rejected the argument that the Port's rights under the loan documents to inspect the property and to take possession upon foreclosure constituted participation in management. It concluded that secured creditors frequently reserve these rights to protect their collateral and they do not rise to the level of participation in management. 910 F.2d at 672. Finally, the court noted that these rights had never been exercised. *Id.* at 673.

*Mirabile* and *Bergsoe* provide the lender with some comfort if the lender has not exercised its rights under the loan documents. Some provisions that may be characterized as "purely financial" or commonly used to protect the lender's security interest may also pass muster. But, these cases fail to define "improper exercise" of loan provisions which constitutes "participation in management."

Section 300.1100 (c)(1) defines participation in management as the lender's "actual participation in the management or operational affairs" of the borrower. It does not cover "the mere capacity to influence, or ability to influence, or the unexercised right to control facility operations."[25] Thus, under the EPA Rule, unexercised loan provisions may not be the basis for liability under CERCLA even if they arguably give the lender the power to control the borrower's facility in some way. The more important question, though, is whether the EPA Rule provides a framework for identifying loan provisions which, when exercised, may constitute participation in management.

The EPA Rule states a general test for participation in management and sets forth a non-exhaustive list of examples. It provides that a lender will be considered to be participating in the management of a borrower if, while the borrower is in possession of the facility, the lender either:

> (i) exercises decisionmaking control over the borrower's environmental compliance, such that the holder has undertaken responsibility for the borrower's hazardous substance 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 holder has assumed or manifested responsibility for the overall management of the enterprise encompassing the day-to-day decisionmaking of the enterprise with respect to (A) environmental compliance or (B) all, or substantially all, of the operational (as opposed to financial or administrative) aspects of the enterprise other than environmental compliance.[26]

The EPA Rule defines operational aspects of an enterprise as those functions handled by a plant manager, operations manager, chief operating officer, or chief executive officer. Financial or administrative functions are identified as those of a credit manager, accounts payable/accounts receivable manager, personnel manager, controller, chief financial officer and others with similar duties.[27]

The general test may be restated with respect to loan documents as follows: a lender will lose the Secured Creditor Exemption if the lender exercises loan provisions in a way (i) that deprives the borrower of decisionmaking control in environmental matters or (ii) that indicates the lender is managing the operational aspects of the borrower's facility. The first prong of this test may be avoided by simply not giving the lender the right to determine the borrower's hazardous substance handling practices or waste disposal practices in the loan documents. Under the EPA Rule, the lender may review the borrower's environmental practices, advise the borrower that it is not in compliance, and require the borrower to get into compliance. But, the lender should not advise the borrower how to clean up or to get into compliance or assist the borrower in developing environmental cleanup or compliance strategies. If an environmental expert or consultant is needed to handle such matters, the lender should not impose its choice upon the borrower. Instead, the lender may provide the borrower with three or four environmental consultants or experts that are acceptable to the lender.

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25. 40 C.F.R. § 300.1100(c)(1) (1992).

26. 40 C.F.R. § 300.1100(c)(1)(i)-(ii).

27. 40 C.F.R. § 300.1100(c)(1)(ii).

In addition, loan documents should be carefully reviewed for provisions that may be exercised in such a way as to give the lender improper control over the borrower's decisionmaking process on environmental matters. For example, commercial mortgages generally permit the lender, in the case of a casualty loss, to choose whether to use insurance proceeds to repair or restore the damaged property or to repay the loan. If the lender elects to apply insurance proceeds to repay the loan instead of allowing these funds to be used to clean up a hazardous spill, the lender may fail the general test and be subject to CERCLA liability.

The second prong of the test focuses on the lender exercising day-to-day overall management control over the operational (as opposed to the financial or administrative) aspects of the borrower's business. Clearly, loan documents should not permit the lender to direct operations at the borrower's plant. But, other customary loan provisions may also lead to problems. For example, if a change in management clause is used to oust borrower's management and to replace it with individuals hand-picked by the lender,[28] the exemption may be lost.

Problems may also arise where the shareholders of a corporate borrower pledge their stock to the lender as security for the loan. The stock pledge agreement usually provides that the lender may not vote the pledged stock unless certain defaults occur. Under the EPA Rule, if a lender votes the stock of the corporate borrower, it could be deemed to be participating in management and thereby lose the Secured Creditor Exemption. This potential "control" issue, which is relevant in the general lender liability area as well as the environmental area, has led some lenders to avoid this type of collateral altogether.

As noted above, the EPA Rule provides concrete examples of activities that do not constitute participation in management. No actions or omissions of the lender before the loan is made and the security interest is taken in the collateral may be characterized as "participation in management."[29] Thus, the loan commitment letter may state the environmental terms and conditions on which a loan will be made without falling outside the exemption. These terms should include the lender's right to require and receive a satisfactory environmental assessment of the property or to terminate the commitment, and the right to require the borrower to clean up and get into compliance.

The EPA Rule further provides that during the loan term, the lender may undertake certain policing activities without losing the exemption. The lender may regularly inspect the borrower's plant facilities and monitor the borrower's business and financial condition. The lender may require the borrower to clean up hazardous conditions and get into compliance. It may also require the borrower to comply with environmental warranties and covenants in the loan documents, all while remaining within the protection of the exemption.[30] Therefore, these rights should be explicitly stated in the Environmental Agreement.

During the "workout" phase, which covers pre-foreclosure activities, the EPA Rule provides that the lender may engage in typical workout activities. These include attempting to prevent, cure, or mitigate the borrower's default, taking steps to preserve or protect the collateral, restructuring or renegotiating loan terms, exercising forbearance, demanding

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28. *See, e.g.*, The State Nat'l Bank of El Paso vs. Farah Mfg. Co., Inc., 678 S.W.2d 661 (Tex. Ct. App. 1984).

29. 40 C.F.R. § 300.1100(c)(2)(i) (1992).

30. 40 C.F.R. § 300.1100(c)(2)(ii)(A).

payment of additional interest or rent, giving specific or general financial advice, and exercising its other rights and remedies without losing the exemption.[31] As with the initial loan documents, the loan forbearance agreement will vary based upon the borrower's circumstances. But, under the EPA Rule, the lender may change financial terms such as the interest rate, the principal repayment schedule, and the maturity date as well as update the environmental requirements without participating in management.

The important caveat that applies to all loan activities and workout activities (but not pre-loan activities), whether they are described in the EPA Rule or not, is that such activities are only protected if they are undertaken in a way that does not fall within the ambit of the general test described above.[32] In drafting loan provisions and in exercising or enforcing them, the lender must always consider the threshold issue of whether the lender in exercising the particular loan provision or provisions has deprived or may deprive the borrower of decisionmaking control over environmental compliance or operational management of its facility. Since this issue is a fact-sensitive one, the lender should proceed with caution particularly where the borrower has environmental problems on its property.

## XI. Environmental Covenants Suggested by the EPA Rule

The EPA Rule highlights some provisions which should be included in the Environmental Agreement to better protect the lender. The EPA Rule confirms the lender's right to inspect the borrower's property and monitor the borrower's environmental compliance procedures during the life of the loan without the lender's action constituting "participation in management." From a lender's perspective, such activity is necessary to update the due diligence investigation made before the closing, to confirm the ongoing accuracy of the environmental representations made at closing, to flush out instances of the borrower's noncompliance with environmental requirements, and to uncover releases of hazardous substances. After a loan has gone bad, it also assists the lender in determining whether to foreclose on the property.

In monitoring the loan, the lender may base the level of monitoring upon the level of due diligence performed before the closing, unless changed circumstances suggest otherwise. If an environmental questionnaire and a site inspection by a bank employee were relied upon originally, those evaluations may be repeated. If the questionnaire and inspection disclose a problem or potential problem, then the lender should require further investigation of the problem through a Phase I Environmental Assessment or some other means. Where a Phase I Assessment was done initially, at a minimum, an environmental questionnaire should be completed and a site inspection by a trained bank employee should be done. The purpose of the inspection is to determine whether conditions have changed since the original Phase I Assessment and whether conditions that were to be corrected have been corrected.

### *A. Update of Environmental Due Diligence*

The lender's right to update environmental due diligence may be stated as follows:

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31. 40 C.F.R. § 300.1100(c)(2)(ii)(B).

32. 40 C.F.R. § 300.1100(c)(ii).

> (a) On or after each year anniversary of the closing date, the borrower shall complete, execute and return to the lender an environmental questionnaire provided by the lender regarding the status of the borrower's property and the borrower's business. Contemporaneously therewith, an authorized representative of the lender shall conduct an environmental inspection of the borrower's property and the borrower's business.
> (b) Based upon the results of the evaluation described in subsection (a) above, the lender, in its sole discretion, shall have the right to require a Phase I environmental assessment of the borrower's property to be conducted, or such other investigation, testing, or sampling as the lender deems appropriate in accordance with this Agreement.
> (c) All expenses incurred by the lender in connection with the exercise of its rights under this section shall be borne by the borrower, including, but not limited to, consultant's fees and attorney's fees.

*B. Lender's Right to Inspect and Monitor Borrower's Business and Property*

The lender's right to inspect and monitor the borrower's business and property is set forth below:

> (a) The lender shall have the right, at any time, from time to time, to enter upon the borrower's property for the purpose of making such audits, tests, inspections and examinations, including, without limitation, subsurface exploration and testing, as the lender, in its sole discretion, deems necessary, convenient, or proper to determine whether the ownership and use of the borrower's property, and the operation of borrower's business on the property are in compliance with federal, state, and local environmental laws, rules, and regulations.
> (b) The lender or its designated agent shall have the right to inspect and copy all of the borrower's records relating to environmental matters and to enter all buildings or facilities of the borrower for such purposes. In confirmation of the lender's right to inspect and copy all of the borrower's records relating to environmental matters and to secure the borrower's obligations to the lender in connection with the loan, and under this right of inspection, the borrower hereby grants to the lender a continuing security interest in and to all of the borrower's existing and future environmental records whether or not located at the borrower's property or elsewhere, whether or not in the possession of the borrower or some third party (including any federal, state, or local agency or instrumentality), and whether or not written, photographic or computerized, and the proceeds and products thereof.
> (c) The lender or its designated agent may interview any and all of the borrower's agents and employees regarding environmental matters, including, without limitation, any consultants or experts retained by the borrower, all of whom are directed to discuss environmental issues fully and openly with the lender or its designated agent and to provide such information as may be requested.
> (d) All of the costs and expenses incurred by the lender with respect to the audits, tests, inspections, and examinations which the lender may conduct, including, without limitation, the fees of the engineers, laboratories, and contractors, shall be paid by the borrower.
> (e) The lender may, but shall not be required to, advance such costs and expenses on

behalf of the borrower. All sums so advanced shall bear interest at the highest rate provided with respect to the loan.

*C. Compliance with Laws; Approvals; Permits and Licenses*

The EPA Rule also provides that a lender may require a borrower to maintain its property in compliance with environmental laws without violating the mandate that the lender should not participate in the management of the borrower. An example of such a provision is as follows:

> (a) The borrower shall maintain the borrower's property in a condition which is in compliance with all applicable environmental requirements, whether or not such requirements concern the presence of hazardous substances, waste, or solid waste.
> (b) The borrower has obtained and shall maintain during the loan term all federal, state, and local approvals, permits, and licenses required to store, treat, and dispose of any hazardous substances used or generated on the property.

*D. Cleanup by Borrower*

The EPA Rule further states that a lender may require a borrower to clean up contamination on the property before the loan is made or during the loan term. An example of such a provision is set forth below:

> If the borrower causes or permits any intentional or unintentional action or omission resulting in the generation, manufacturing, refining, transportation, treatment, storage, handling, disposal, release, spill, leak, pumping, pouring, emitting, emptying, or dumping of hazardous substances, the borrower shall promptly clean up all such hazardous substances in accordance with all applicable federal, state, and local environmental laws, regulations, and rules.

*E. Borrower's Notice to Lender of any Environmental Conditions*

To properly monitor the environmental condition of the borrower's property as permitted by the EPA Rule, the lender must be advised of the discovery of any pre-existing environmental conditions or the occurrence of any release:

> The borrower shall notify the lender of any release of hazardous substances onto the property, any adjacent property, or any other property, or into the air or water within three (3) days of such release.

This notice provision is another method the lender may use to obtain information about the property which is likely to affect the value of the property as security for the loan.

## XII. Conclusion

It is too soon to know the full impact of the EPA Rule on the lending community. From a drafting perspective, the EPA Rule does address the concern arising from the *Fleet Factors*

decision and others[33] that a lender may be held liable under CERCLA based merely on the existence of loan provisions, which appear to give the lender "a capacity to influence" the borrower's decisionmaking process on environmental matters or management of its facility. The EPA Rule also provides the lender with guidance on the types of pre-loan, loan, and workout activities which are protected by the exemption. Although the EPA Rule may not be a complete cure for all the uncertainties that ail lenders in the area of environmental lender liability, it certainly has circumscribed the gray area created by the *Fleet Factors* decision. Furthermore, lenders can reap the full benefits of the EPA Rule through thoughtful analysis and careful crafting of new protective loan provisions based upon the EPA Rule to further minimize environmental lender liability exposure.

33. *See, e.g.*, United States v. Mirabile, 15 Envtl. L. Rep. (Envtl. L. Inst.) 20,992 (E.D. Pa. Sept. 4, 1985); In Re Bergsoe Corp., 910 F.2d 668 (9th Cir. 1990).

## APPENDIX "A"

The environmental terms used in this article have the definitions stated below:

"Hazardous Substances" shall mean and include any material or matter that contains:

(i) any hazardous substance, pollutant or contaminant as defined in any applicable federal statute, law, rule, or regulation, now or hereafter in effect, including, but without limitation, §§ 101(14) and (33) of the Comprehensive Environmental Response, Compensation and Liability Act (42 U.S.C. §§ 9601(14) and (33)(1988)) or 40 C.F.R. § 302 (1992) or the Federal Water Pollution Control Act Amendments of 1972, 33 U.S.C. § 1321 (1988), or any amendment thereto or any replacement thereof, or in any statute or regulation relating in any way to the environment, whether similar or dissimilar, now or hereafter in effect;

(ii) any hazardous substance or hazardous waste, as those terms are now or hereafter defined in any applicable state or local law, rule, or regulation, or in any statute or regulation relating in any way to the environment, whether similar or dissimilar, now or hereafter in effect;

(iii) any solid waste, as defined in any federal, state, or local statute, law, rule, or regulation, now or hereafter in effect, or any amendments thereto or any regulations promulgated thereunder;

(iv) any substance subject to the Emergency Planning and Community Right-to-Know Act of 1986, 42 U.S.C. §§ 11001-11050 (1988), or any state or local community right-to-know act, or the regulations promulgated thereunder or in any replacement thereof or in any similar statute or regulation now or hereafter in effect;

(v) any substance containing petroleum, as defined in § 9001 (8) of the Resource Conservation and Recovery Act, as amended (42 U.S.C. § 6991(8)(1988)) or 40 C.F.R. § 280.1 (1992), or in any amendment thereto or any replacement thereof or in any similar statute or regulation now or hereinafter in effect;

(vi) any medical waste as defined in any federal, state, or local medical waste management act, or in any amendment thereto or any replacement thereof or in any similar statute, law, or regulation now or hereinafter in effect;

(vii) any toxic or chemical substance as those terms are defined in the Toxic Substances Control Act, 15 U.S.C.§ 2601-2689 (1988 & Supp. 1992), or in any amendment thereto or any replacement thereof or in any similar statute or regulation now or hereinafter in effect; and

(viii) any other substance for which any federal, state, or local governmental entity now or hereafter requires special handling in its use, transportation, accumulation, collection, storage, treatment, or disposal.

"Release" or "Releasing" shall mean releasing, spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, disposing, or dumping into the environment or into a facility or holding device that poses an immediate threat of contamination to the environment.

"Damages" shall mean all liabilities, obligations, claims, demands, controversies, actions, suits, causes of action, orders, writs, and judgments, including, but without limitation, costs, expenses, attorney's fees, consultant's fees, environmental cleanup costs, natural resources damage, fines, penalties, consequential damages, injury, death or other damages relating to person(s), personal or real property, and business enterprises, now or in the future, as determined by the lender in its sole discretion arising out of or relating to any environmental condition related to the property, including, but not limited to:

(i) any actual or threatened release of any hazardous substance;
(ii) any violation of any federal, state or local environmental law that is caused, suffered, allowed, or permitted by borrower; or
(iii) any other condition that may cause the lender to sustain any damages, regardless of whether such environmental condition resulted from any act or omission of the borrower, the lender, one or more third parties, or some combination thereof including, but without limitation, any negligence of the lender whether before, now, or hereafter existing or occurring.

"Environmental Requirements" shall mean any and all applicable federal, state, or local environmental laws, statutes, ordinances, regulations, guidelines or standards, administrative or court orders or decrees, or private agreements, now or hereinafter in effect.
"Notice" shall mean any summons, citation, directive, order, claim, litigation, investigation, proceeding, judgment, letter or other communication, written or oral, actual or threatened, from the United States Environmental Protection Agency, or any other federal, state, or local agency or authority or any other entity or individual concerning any intentional and unintentional act or omission which has resulted or which may result in the releasing of hazardous substances into the waters or onto the lands of the State of [ ] or into the "environment" (as defined in CERCLA)[34] for or on the property. Notice includes the imposition of any lien upon the property pursuant to any violation of federal, state, or local environmental laws, ordinances, rules, regulations, government actions, orders or permits, or any knowledge after due inquiry and investigation of any facts which could give rise to any of the foregoing.

34. 42 U.S.C. § 9601(8)(1988). CERCLA defines the "environment" as "(A) the navigable waters, the waters of the contiguous zone, and the ocean waters of which the natural resources are under the exclusive management authority of the United States under the Magnuson Fishery Conservation and Management Act of 1976 [16 U.S.C. §§ 1801-1882 (1988 & Supp. III 1991)], and (B) any other surface water, ground water, drinking water supply, land surface or subsurface strata, or ambient air within the United States or under the jurisdiction of the United States."