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Lender Beware: Navigating the Superfund safe harbor during workouts and foreclosures.

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Virtually every financial institution is aware that a borrower's contaminated assets can give rise to significant environmental liability in the workout and foreclosure context. To a certain extent, however, lenders may have been lulled into a false sense of security after Congress amended the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) in 1996 to clarify and expand a statutory safe harbor for lenders. Although that amended safe harbor provides banks with considerable comfort, it has not been fully tested, especially in hard economic times, and the case law interpreting its limits is surprisingly sparse. A recent enforcement action brought against a major bank in New York, which resulted in a settlement of nearly $1 million, highlights the need for vigilance and caution.

With the current economic downturn, the increased volume and pace of workout and foreclosure activity are likely to push the outer boundaries of CERCLA's safe harbor exemption. Now more than ever financial institutions should be certain that they understand the subtleties and limits of CERCLA's safe harbor requirements and, just as importantly, that their workout professionals proceed with an acute awareness that their actions and inactions could attract environmental liability if they are not carefully calibrated to remain within the safe harbor.

Risk Under Superfund

Since its enactment in 1980, CERCLA has imposed joint and several liability on owners and operators of contaminated facilities. Even as originally enacted, however, CERCLA included an exemption from liability for any lender that "without participating in the management of a . . . facility, holds indicia of ownership primarily to protect his security interest."[1] This broad but vague exemption provided little practical guidance and in fact created considerable legal uncertainty.

Lender concerns were heightened in 1990 after *United States v. Fleet Factors* was decided.[2] In *Fleet Factors*, a lender's agent sold off inventory and equipment at a borrower's site but abandoned 700 drums of toxic chemicals and 44 truckloads of material containing asbestos. The Environmental Protection Agency (EPA) incurred response costs to address the issue, and then sued the lender under CERCLA for recovery of those costs.

Instead of finding the bank liable on the narrow ground that its agent's abandonment of hazardous substances created a threat of environmental release, the *Fleet Factors* court asserted that a lender could attract CERCLA liability whenever it had even the mere "capacity to influence" waste handling through financial oversight. This broad language, which was not strictly necessary for the decision, sent shock waves through the financial community.

EPA's Lender Liability Rule

EPA responded to *Fleet Factors* by issuing a Lender Liability Rule[3] designed to protect lenders from unbounded exposure to CERCLA liability. The Lender Liability Rule articulated broad principles of safe conduct as guidance for financial institutions, and also identified specific lender activities that would not typically be deemed to attract CERCLA liability.

The rule was vacated on technical administrative law grounds in 1994.[4] Following this setback, the U.S. Department of Justice and EPA issued a joint memorandum announcing their shared intent to rely upon the Lender Liability Rule as guidance for enforcement actions. This statement provided some comfort to lenders, but only with respect to government enforcement actions. The guidance had no force of law in private party litigation. As a result, lenders engaged in broad lobbying efforts to secure clear statutory protection.

Congressional Action

In 1996 Congress effectively codified the Lender Liability Rule when it amended Superfund by enacting the Asset Conservation, Lender Liability and Deposit Insurance Act. This legislation eliminated much of the uncertainty created by the *Fleet Factors* decision by expanding and clarifying the lender safe harbor. Although there is no question that the law is now much clearer than it was before Congress acted, the outer limits of the CERCLA safe harbor are not always crisply defined, and therefore require real-time attention as financial institutions engage in workout activity.

Pre-Foreclosure Safe Harbor

In the pre-foreclosure context, a lender can attract CERCLA liability if it: undertakes decision-making control over and responsibility for hazardous substance handling or disposal practices; or exercises control at a level comparable to that of a facility manager, such that the lender either assumes or manifests responsibility for:

- day-to-day environmental compliance of the facility; or

- all or substantially all of the operational functions (as distinguished from financial or administrative functions) of the facility other than environmental compliance.[5]

CERCLA's safe harbor provisions also identify activities that are not generally considered to attract environmental liability, so long as they do not rise to the level of facility management or direct involvement in waste handling or disposal described above. These activities include:

- conducting or directing environmental assessments of facilities;

- taking a security interest in contaminated property;

- including environmental representations, warranties, and covenants in loan documents;

- monitoring or enforcing a borrower's compliance with environmental covenants;

- requiring a cleanup;

- enforcing default rights in loan documents that relate to environmental compliance;

- providing financial or other advice or counseling in an effort to mitigate, prevent, or cure default or diminution in the value of the facility;

- restructuring, renegotiating or otherwise agreeing to alter the terms and conditions of

the extension of credit or security interest, including exercising forbearance.[6]

Although these listed activities are generally considered to be exempt from environmental liability, even "safe" activities are subject to an overarching requirement that the lender not become pervasively involved in facility management or assume decision-making control over waste handling or waste disposal matters. Accordingly, in exercising the enumerated rights set forth in the law, lenders would be well advised to closely examine whether the totality of their actions could be seen as being offside at some point in the future. They also should be careful not to unwittingly cause or contribute to an environmental release, for example, when a facility is being decommissioned or prepared for sale. Further, a lender might think twice before withholding funds to address an imminent threat to public health or the environment caused by the shutdown of a borrower's facility, even if it would otherwise have the right under its loan documents to make tough fiscal decisions with respect to a buyer in default.

Safe Harbor for Foreclosure

The CERCLA safe harbor also expressly permits lenders to foreclose on contaminated property, maintain business activities, wind up operations, and preserve, protect or prepare the property for sale or other disposition.[7] This aspect of the safe harbor carries with it a very significant caveat, however. Foreclosure activity is only protected if the lender "seeks to sell, re-lease or otherwise divest itself of the property at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."[8]

EPA considered whether to create a bright-line test for this safe harbor (such as creating a set period of time for subsequent sale), but declined to do so, opting instead for a facts-and-circumstances approach which creates uncertainty for lenders seeking to sell foreclosed properties in a challenged market. For example, EPA indicated in comments on its 1992 rulemaking that if a lender receives a lowball offer on property and rejects that offer in favor of keeping the property on the market, such a decision might be regarded as being more consistent with the acts of an "owner" than a "lender," and might cause the lender to attract CERCLA liability. In close cases, therefore, before a lender rejects an offer on a property in foreclosure, it should be prepared to establish that the offer was commercially unreasonable, and be able to justify that decision with appropriate support and analysis if the decision is later called into question.

Case Interpretation

Since passage of the CERCLA amendments, the majority of reported cases have upheld lender claims that their activities fell within the safe harbor. For example, in *U.S. v. Pesses*,[9] a Pennsylvania court held that a lender met the requirements of the CERCLA safe harbor when it did not participate in management of the facility and, following foreclosure, promptly listed the property with several real estate agents, entertained inquiries about the site from interested parties, leased part of the property with rental payments credited toward an outstanding loan balance, engaged an environmental consultant to test for hazardous substances, and, upon concluding it could not sell the property without engaging in a multi-million dollar cleanup, turned the keys of the property over to a bankruptcy trustee.

Similarly, in *Organic Chem. Site PRP Group v. Total Petroleum Inc.*,[10] a Michigan court held that the mere opportunity to participate in site management under a retained lease interest did not rise to the level of actual participation which could defeat the secured creditor exemption. Notwithstanding these decisions, the case law defining the outer limits of the CERCLA safe harbor remains quite sparse, making it difficult in close cases to predict how a particular set of facts will be viewed with 20-20 hindsight by a regulator or a court.

Activity in New York

A recent complaint filed by the State of New York against HSBC and a resulting settlement of nearly $1 million illustrates the risks inherent for lenders engaged in workout activities involving environmentally sensitive properties.[11] According to the complaint, after HSBC's borrower, Westwood Chemical Corporation, defaulted on its loan, the bank seized Westwood's operating funds and requested a plan for the orderly shutdown of its facility. Westwood submitted a plan that included costs to properly dispose of waste at the site. The lender allegedly refused to fund these waste disposal costs, and also refused to fund shipment of finished chemical products, which resulted in them being abandoned.

After the facility was shut down, hundreds of containers of hazardous waste and hazardous substances leaked after a winter freeze. The lender also allegedly failed to notify the state Department of Environmental Conservation (DEC) of the threat posed by the abandonment of hazardous waste and hazardous substances at the site.

DEC asserted that "HSBC's actions in taking control of Westwood's finances, in refusing to fund an orderly shut down plan, in refusing to fund shipment of finished chemical products and the completion of work in progress, in retaining contractors to perform work at the Site, and in otherwise exercising control over the Site, directly and/or indirectly caused the abandonment, disposal, release and threat of release of hazardous waste and hazardous substances to the environment from the Site." DEC further alleged that "HSBC ignored its legal obligation to exercise due care when exerting such authority and control over the Site," and "ignored its legal obligation to report the release or threat of release, or the spill and discharge of hazardous substances and hazardous waste to the environment to DEC and other local, State and federal officials."

HSBC denied DEC's allegations (and may well have had valid defenses to the state's allegations), but resolved the matter in a consent decree that required reimbursement of the state for $115,680 in response and enforcement costs, and also included payment of a civil penalty in the amount of $850,000.

Navigating the Shoals

As can be seen from the allegations against HSBC, although CERCLA's safe harbor may appear clear and specific on its face, its proper application can be a challenge. Real-time assessment and reassessment of applicable requirements may be necessary during the course of a complicated workout or foreclosure. For example, a decision by a bank officer not to fund a particular course of action in the context of a workout could have unintended and dramatic environmental consequences, as allegedly took place in the HSBC matter.

The art of managing environmental risks well through this process is knowing when an action (or in some cases even a failure to act) is approaching the outer limits of the safe harbor. In particular, care should be taken to ensure that the bank's agents do not themselves cause an environmental release while taking actions on the bank's behalf.

In close cases, input from an environmental professional will add significant value and help to identify pitfalls that might not be spotted by a bank officer focused mostly on fiscal issues. Moreover, because the CERCLA safe harbor is inherently fact-specific, there is no one-size-fits-all blueprint for success, and the bank's conduct will be evaluated by regulators and the courts

with the benefit of 20-20 hindsight. Nuanced assessment of litigation and regulatory risk may well be advisable in close cases. As workout and foreclosure activity multiplies in the coming months, lenders should be careful to calibrate and monitor their actions to remain squarely within the safe harbor.

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Endnotes:

1. 42 USCA §§9601(20)(A), 9607(a)(2).

2. 901 F.2d 1550 (11th Cir. 1990), cert. denied, 498 U.S. 1046 (1991).

3. 57 Fed. Reg. 18344 (1992).

4. 15 F.3d 110, reh'g denied, 25 F.3d 1088 (D.C. Cir. 1994).

5. 42 USC §9601(20)(F).

6. 42 USC §9601(20)(F).

7. 42 USC §9607(n)(4).

8. 42 USC §9601(20)(E)(ii).

9. 1998 WL 937235 (W.D. Pa. May 6, 1998).

10. 58 F.Supp.2d 755 (W.D. Mich. 1999).

11. *New York v. HSBC Bank USA, Nat'l Ass'n*, Docket No. 07-CV-3160 (Dec. 22, 2006 Consent Decree).