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Roger J. Marzulla

Brett G. Kappel

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LENDER LIABILITY UNDER THE COMPREHENSIVE ENVIRONMENTAL RESPONSE, COMPENSATION AND LIABILITY ACT

ROGER J. MARZULLA*

BRETT G. KAPPEL**

I. INTRODUCTION

The Superfund¹ hazardous waste cleanup program has its roots in one of the most dramatic environmental and public health stories of recent decades—Love Canal.² As industrial wastes and toxic substances buried decades earlier at Love Canal began seeping into basements and bubbling to the surface, America's awakening environmental consciousness mobilized to bring about adoption of the most far-

* Partner, Powell, Goldstein, Frazer & Murphy, Washington, D.C. Mr. Marzulla concentrates his practice on environmental law and is formerly Assistant Attorney General, Land and Natural Resources Division, U.S. Justice Department. B.A., University of Santa Clara, 1968; J.D., University of Santa Clara School of Law, 1971.

** Associate, Powell, Goldstein, Frazer & Murphy, Washington, D.C. B.A., State University of New York at Albany, 1980; J.D., University of Virginia School of Law, 1990.

1. "Superfund" is the popular name for the hazardous waste cleanup program established by the Comprehensive Environmental Response, Compensation and Liability Act of 1980, Pub. L. No. 96-510, 94 Stat. 2767 (1980) (codified as amended at 42 U.S.C.A. §§ 9601-9675 (West 1983 & Supp. 1989)) [hereinafter CERCLA].

2. See, Silverman, *Love Canal: A Retrospective*, 20 Env't Rep. (BNA) No. 20-Part II, at 835 (Sept. 15, 1989).

reaching and expensive environmental program ever undertaken. Drafted hurriedly to address a perceived environmental emergency,³ CERCLA devised a unique liability scheme whose breadth and reach only now are starting to be comprehended. Indeed, one searches in vain among the legislative debates of the time to find any substantive reference to the role of banks, real estate developers or secured parties in the hazardous waste cleanup program. Yet today, a mere ten years after adoption of the statute, perhaps seventy percent of major real estate transactions (not to mention corporate mergers and acquisitions) involve significant environmental concerns, and few real estate transactions go forward without an environmental audit.⁴

How has a toxic waste cleanup program aimed at industrial polluters become a major hurdle in many modern real estate transactions? By what star can real estate investors steer the uncharted waters of Superfund liability? This article attempts to provide some guidance by first describing the operation of the Superfund program, next applying its concepts to lending and real estate transactions, and finally suggesting some strategies for dealing with environmental liabilities inherent in today's real estate and lending marketplace.

II. THE THEORY OF CERCLA LIABILITY

Novel problems beget novel legislation, and the CERCLA liability scheme adopted by Congress is a legislative collection of concepts drawn from tort, property, contract, and agency law principles engrafted upon a massive national program of hazardous waste cleanup. Under CERCLA, a potentially responsible party (PRP) is not only strictly liable regardless of the care exercised in disposing of the waste,⁵ and severally liable for the entire cost of cleanup regardless of

3. CERCLA's hurried passage in the closing hours of the 96th Congress led to a legislative history which could be described most charitably as poor. The lack of a definitive legislative history has handicapped courts attempting to construe the statute's broadly drafted provisions. The comments of Chief Judge Russell G. Clark of the United States District Court for the Western District of Missouri are typical: "CERCLA is in fact a hastily drawn piece of compromise legislation, marred by vague terminology and deleted provisions. . . . [N]umerous important features were deleted during the closing hours of the Congressional session. The courts are once again placed in the undesirable and onerous position of construing inadequately drawn legislation." *United States v. Northeastern Pharmaceutical & Chem. Co.*, 579 F. Supp. 823, 838-39 n.15 (W.D. Mo. 1984) (citations omitted), *aff'd in part, rev'd in part*, 810 F.2d 726 (8th Cir. 1986), *cert. denied*, 484 U.S. 848 (1987).

4. See O'Brien, *Environmental Due Diligence: Introduction* in ENVIRONMENTAL DUE DILIGENCE: THE COMPLETE RESOURCE GUIDE FOR REAL ESTATE LENDERS, BUYERS, SELLERS, AND ATTORNEYS (J. O'Brien & W. Frank eds. 1989).

5. *E.g.*, *United States v. Monsanto Co.*, 858 F.2d 160, 170 (4th Cir. 1988), *cert. de-*

how many other PRPs there may be (when these costs are indivisible).⁶ Apart from proving that someone else was the sole cause of the release of the hazardous substance into the environment, the defendant in a Superfund suit has only two legally-allowable defenses: (1) that the release was caused by an act of war, or (2) that it was caused by an act of God.⁷ A PRP may not seek court relief while the government is cleaning up the site with money drawn from the Superfund, but must wait until the government has completed all of the work.⁸ When a PRP finally does get to court, it is not entitled to a jury trial. Furthermore, the PRP may present little, if any, evidence in the case, since review by the court is limited to the administrative record prepared by the government,⁹ whose judgments are entitled to deference by the court unless they are found to be arbitrary and capricious.¹⁰

Section 104 of CERCLA authorizes the federal government to respond to the release¹¹ or threatened release of a hazardous substance¹² into the environment by taking any action "necessary to protect the public health or welfare or the environment."¹³ In order to pay for

nied, 109 S. Ct. 3156 (1989); *United States v. Bliss*, 667 F. Supp. 1298, 1304 (E.D. Mo. 1987); *United States v. Dickerson*, 640 F. Supp. 448, 451 (D. Md. 1986).

6. See, e.g., *Monsanto*, 858 F.2d at 171; *Bliss*, 667 F. Supp. at 1312-13; *United States v. Stringfellow*, 661 F. Supp. 1053, 1060 (C.D. Cal. 1987).

7. CERCLA § 107(b), 42 U.S.C. § 9607(b) (1982 & Supp. V 1987).

8. CERCLA § 113(h), 42 U.S.C. § 9613(h) (Supp. V 1987).

9. CERCLA § 113(j)(1), 42 U.S.C. § 9613(j)(1) (Supp. V 1987).

10. CERCLA § 113(j)(2), 42 U.S.C. § 9613(j)(2) (Supp. V 1987).

11. Section 101(22) of CERCLA defines a "release" as "any spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping, or disposing into the environment (including the abandonment or discarding of barrels, containers, and other closed receptacles containing any hazardous substance or pollutant or contaminant)" CERCLA § 101(22), 42 U.S.C. § 9601(22) (Supp. V 1987).

12. Section 101(14) of CERCLA defines "hazardous substance" to include a large number of materials regulated under other federal environmental statutes. The list of hazardous substances includes those that are regulated under section 311(b)(2)(A) of the Federal Water Pollution Control Act, 33 U.S.C. § 1321(b)(2)(A) (1982 & Supp. V 1987); hazardous wastes that have the characteristics identified in section 3001 of the Solid Waste Disposal Act, 42 U.S.C. § 6921 (1982 & Supp. V 1987); toxic pollutants listed under section 307(a) of the Federal Water Pollution Control Act, 33 U.S.C. § 1317(a) (1982 & Supp. V 1987); hazardous air pollutants listed under section 112 of the Clean Air Act, 42 U.S.C. § 7412 (1982); and hazardous substances that are regulated under section 7 of the Toxic Substances Control Act, 15 U.S.C. § 2606 (1988). See 42 U.S.C. § 9601(14) (Supp. V 1987). This Article uses the terms hazardous wastes and hazardous substances interchangeably.

13. CERCLA § 104(a)(1), 42 U.S.C. § 9604(a)(1) (Supp. V 1987). Section 104 response actions take one of two forms. A removal action is an immediate action taken to "prevent, minimize, or mitigate damage to the public health or welfare or to the environment, which may otherwise result from a release or threat of release." CERCLA § 101(23), 42 U.S.C. § 9601(23) (Supp. V 1987). Removal actions include providing fencing to limit access to the hazardous waste site, furnishing alternative water supplies and

these governmental response actions, CERCLA established the Hazardous Substances Response Trust Fund, popularly known as the Superfund.¹⁴ If the federal government taps the Superfund to pay for a response action, it may then sue the potentially responsible parties to recover its costs.¹⁵

Section 107 of CERCLA sets forth the following four classes of persons¹⁶ who may be held liable for remedial response costs: (1) the current owner or operator of a hazardous waste disposal facility;¹⁷ (2) any person who owned or operated such a facility at the time of waste disposal; (3) hazardous waste generators who arranged for the disposal of such waste at the facility; and (4) transporters of hazardous waste who selected the facility for the disposal of hazardous waste.¹⁸

As a result of congressional deadlock over the appropriate standard of liability, CERCLA as originally adopted failed to specify clearly the standard that courts were to apply in Superfund cases. Sub-

temporarily evacuating potentially affected individuals. *Id.* In contrast, a remedial action is a permanent remedy designed "to prevent or minimize the release of hazardous substances so that they do not migrate to cause substantial danger to present or future public health or welfare or the environment." CERCLA § 101(24), 42 U.S.C. § 9601(24) (Supp. V 1987). Remedial actions include containing hazardous wastes within earthen dikes and then capping the waste site with a clay cover. *Id.*

14. CERCLA § 221, 42 U.S.C. § 9631 (1982) (repealed). Congress originally approved \$1.6 billion for the Superfund. Of this amount, 87.5% came from a special tax on petroleum and other chemicals, *see* 26 U.S.C. §§ 4611-4612, 4661-4662 (1982 & Supp. V 1987), and 12.5% came from general appropriations, *see* 42 U.S.C. § 9631(b)(2) (1982) (repealed 1986). The Superfund Amendments and Reauthorization Act of 1986, Pub. L. No. 99-499, 100 Stat. 1613 (1986) [hereinafter SARA], significantly expanded the Superfund in 1986, making \$8.5 billion available to fund response actions undertaken during the five years ending in 1991. *See* Superfund Revenue Act of 1986, Pub. L. No. 99-499, §§ 501-531, 100 Stat. 1613, 1760-1782 (1986).

15. CERCLA § 107, 42 U.S.C. § 9607 (1982 & Supp. V 1987).

16. Section 101(21) of CERCLA defines the term "person" to include "an individual, firm, corporation, association, partnership, consortium, joint venture, commercial entity, United States Government, State municipality, political subdivision of a state, or any interstate body." 42 U.S.C. § 9601(21) (Supp. V 1987).

17. Section 101(9) of CERCLA defines a "facility" as follows:

(A) any building, structure, installation, equipment, pipe or pipeline (including any pipe into a sewer or publicly owned treatment works), well, pit, pond, lagoon, impoundment, ditch, landfill, storage container, motor vehicle, rolling stock, or aircraft, or (B) any site or area where a hazardous substance has been deposited, stored, disposed of, or placed, or otherwise come to be located . . .

CERCLA § 101(9), 42 U.S.C. § 9601(9) (Supp. V 1987). In addition, the courts have given this term a very broad interpretation so that today virtually any site where hazardous wastes have come to rest qualifies as a facility for purposes of CERCLA liability. *See, e.g.,* New York v. General Elec. Co., 592 F. Supp. 291, 296 (N.D.N.Y. 1984) (drag strip which had been sprayed with oil contaminated with polychlorinated biphenyls (PCBs) determined to be a facility under CERCLA).

18. CERCLA § 107, 42 U.S.C. § 9607 (Supp. V 1987).

sequent judicial interpretation, however, has confirmed that all classes of PRPs are strictly liable,¹⁹ and that they incur joint and several liability for all cleanup costs unless the contribution of each party to the need for cleanup is clearly severable.²⁰ Thus, the proverbial "one barrel generator" at a Superfund site may be held liable for the entire cost of cleanup, as may the owner or operator of the site, unless one of three available statutory defenses can be proved.

As stated earlier, section 107(b) of CERCLA provides that a potentially responsible party can avoid liability if the PRP can establish by a preponderance of the evidence that the release of hazardous substances was caused solely by an act of God, an act of war, or was the sole act or omission of a third party who has no contractual relationship to the potential defendant.²¹ The third-party defense is available, however, only if the potential defendant took precautions against the foreseeable acts or omissions of the third party.²²

In 1986, the Superfund Amendments and Reauthorization Act (SARA) modified the third-party defense by defining the term "contractual relationship" to include instruments transferring title or possession to real property unless the purchaser did not know or had no reason to know that hazardous substances had been disposed of on the property.²³ In order to invoke this innocent landowner defense, purchasers of real property must show that at the time of purchase they made "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice in

19. Section 101(32) of CERCLA defines the standard of liability as the same standard which applies under section 311 of the Federal Water Pollution Control Act, 33 U.S.C. § 1321 (1982 & Supp. V 1987). See CERCLA § 101(32), 42 U.S.C.A. § 9601(32) (West Supp. 1989). At the time that CERCLA was adopted, a substantial body of case law interpreted section 311 of the Federal Water Pollution Control Act as establishing a standard of strict liability. See, e.g., *United States v. LeBeouf Bros. Towing Co.*, 621 F.2d 787, 789 (5th Cir. 1980), *cert. denied*, 452 U.S. 906 (1981); *United States v. Tex-Tow, Inc.*, 589 F.2d 1310, 1313 (7th Cir. 1978). Courts have relied on Congress's knowledge of these earlier rulings to decide that CERCLA calls for a standard of strict liability. See *New York v. Shore Realty Corp.*, 759 F.2d 1032, 1042 (2d Cir. 1985); *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573, 576 (D. Md. 1986); *United States v. Conservation Chem. Co.*, 589 F. Supp. 59, 62 (W.D. Mo. 1984); *United States v. Northeastern Pharmaceutical & Chem. Co.*, 579 F. Supp. at 843-44 (W.D. Mo. 1984), *aff'd in part, rev'd in part*, 810 F.2d 726 (8th Cir. 1986), *cert. denied*, 484 U.S. 848 (1987); *United States v. Chem-Dyne Corp.*, 572 F. Supp. 802, 805 (S.D. Ohio 1983).

20. See, e.g., *United States v. Monsanto Co.*, 858 F.2d 160, 171-72 (4th Cir. 1988), *cert. denied*, 109 S. Ct. 3156 (1989); *Conservation Chem. Co.*, 619 F. Supp. at 199; *Northeastern Pharmaceutical & Chem. Co.*, 579 F. Supp. at 844.

21. See *supra* note 7 and accompanying text.

22. CERCLA § 107(b)(3), 42 U.S.C. § 9607(b)(3) (1982 & Supp. V 1987).

23. CERCLA § 101(35)(A), 42 U.S.C. § 9601(35)(A) (Supp. V 1987).

an effort to minimize liability.”²⁴

The innocent landowner defense effectively added a third element of proof to the third-party defense. Today, in order to establish the third party defense, a defendant must establish, by a preponderance of the evidence, that it (1) exercised due care with regard to the hazardous substance, (2) took precautions against the foreseeable acts or omission of the third party, and (3) purchased the property without knowing or having reason to know that the property was contaminated by hazardous substances.²⁵

III. LENDER LIABILITY UNDER CERCLA

Aimed at hazardous waste generators, the CERCLA of 1980 makes only awkward reference to security interests in real property,²⁶ underscoring the lack of input from the real estate and banking industries in the drafting of the statute. Although CERCLA imposes strict liability upon the owner of property, little thought seems to have been given to the potential liability of a secured lender who forecloses, thereby taking title. Congress also did not define with great specificity the term “operator” (of a hazardous waste facility), opening the door to the argument that the imposition of certain loan conditions upon a borrower who handles hazardous waste may render the lender an operator of the hazardous facility. In fact, it may be said that the issue of lender liability was almost completely overlooked by Congress in drafting the

24. CERCLA § 101(35)(B), 42 U.S.C. § 9601(35)(B) (Supp. V 1987). In deciding whether a defendant has made an appropriate inquiry, courts are directed to consider any expertise possessed by the defendant, the purchase price of the property as compared to its value if uncontaminated, reasonably ascertainable information about the property, the obviousness of contamination at the site and the ability to detect such contamination by an appropriate inspection. *Id.*

25. Section 101(35)(A) of CERCLA states that in addition to establishing that the purchaser had no reason to know that the property was contaminated, “the defendant must establish that he has satisfied the requirements of section 9607(b)(3)(a) and (b) of this title.” 42 U.S.C. § 9601(35)(A) (Supp. V 1987).

26. Section 101(20)(A) of CERCLA provides that the term “‘owner or operator’ . . . does not include a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility.” 42 U.S.C. § 9601(20)(A) (Supp. V 1987). The legislative history of CERCLA is similarly uninformative. The report of the House Committee on Merchant Marine and Fisheries on an earlier version of the legislation which eventually became CERCLA states only that the provision was intended to exclude from liability “persons possessing indicia of ownership (such as a financial institution) who, without participating in the management or operation of a vessel or facility, hold title either in order to secure a loan or in connection with a lease financing arrangement under the appropriate banking laws, rules, or regulations.” H.R. REP. NO. 172, 96th Cong., 2d Sess., pt. 1., at 36, *reprinted in* 1980 U.S. CODE CONG. & ADMIN. NEWS 6160, 6181.

Superfund scheme. Thus, it has fallen to the courts to define the nature and extent of this liability. Likewise, it has fallen to counsel for banks, developers and investors to struggle with forecasts of the outcome of this unpredictable litigation. The fundamental principles of lender liability under CERCLA are derived from a handful of district court decisions and remain subject to changes in the direction of the government's environmental enforcement program as well as the vagaries of appellate review.

The crux of the problem is rooted in the metaphysics of real estate secured transactions. Whether the lender itself takes legal title or that title remains legally in the borrower or is transferred to a third-party trustee under a deed of trust, all secured parties have a right to foreclose the mortgagor's interest in the security to pay off a defaulted loan. Whether the property is located in a "lien theory" or "title theory" state,²⁷ the result of the foreclosure is the same: unless a third party overbids the amount of the loan (plus allowable fees and costs), the lender ends up taking title to the property. Hence, the first critical CERCLA interpretation for lenders is whether a foreclosing lender who takes title thereby becomes an "owner" liable under the statute.

A. *The Lender as Owner*

As originally enacted, CERCLA defined the term "owner or operator" of a hazardous waste facility as follows:

[i]n the case of an onshore facility or an offshore facility, [the term includes] any person owning or operating such facility *Such term does not include a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility.*²⁸

There is virtually no legislative history to explain the exact purpose Congress intended to serve by creating this security interest ex-

27. The nature of the security interest that a lender has in secured property during the term of the mortgage is treated differently by different states. Under the "title theory," the lender holds title to the real property until the entire mortgage debt has been satisfied, whereupon title to the property passes to the borrower. Thirteen states follow this rule. See *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573, 599 (D. Md. 1986). The majority of states, however, follow the "lien theory," which holds that during the term of the mortgage the lender merely has a first priority lien on the secured real property. Under the "lien theory," then, the borrower holds title to the property at all times. See G. OSBORNE, G. NELSON & D. WHITMEN, *REAL ESTATE FINANCE LAW* §§ 1.5, 4.1, 4.2 (1979).

28. 42 U.S.C. § 9601(20)(A) (1982) (emphasis added), amended by 42 U.S.C. § 9601(20)(A) (Supp. V 1987).

emption.²⁹ If anything, what little legislative history exists indicates that the security interest exemption was intended to apply to a variety of financing arrangements—not just those used to purchase real property.³⁰ Commentators have interpreted this provision as a conscious policy choice by Congress to exempt lenders from liability under CERCLA in order to serve other goals.³¹ The courts that have interpreted this provision, however, have come to the conclusion that lenders may be held liable for CERCLA cleanup costs.³²

In *United States v. Maryland Bank & Trust*,³³ the court found a foreclosing lender liable under CERCLA, sending shock waves through the nation's financial institutions. Until that decision, the lending community (if it thought about Superfund liability at all) glanced at the so-called "security interest exemption" under the statute and assumed that lenders had nothing to fear. After all, the definition of "owner" specifically excluded "a person who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility."³⁴ It seemed to follow, they thought, that a foreclosing lender would not become a CERCLA "owner" merely by reason of the foreclosure. Properly understood, they reasoned correctly.

Maryland Bank & Trust involved a lender who held a security interest in property which had been used for the disposal of 237 drums of hazardous waste. When the borrower defaulted, the lender instituted a foreclosure action and subsequently purchased the property at the foreclosure sale. One year after the lender purchased the property, the former owner notified state officials that hazardous wastes had been dumped on the site and the Environmental Protection Agency (EPA) initiated a response action. The EPA then brought suit against

29. See *supra* note 3 (discussing scant legislative history of CERCLA).

30. See *supra* note 26.

31. See, e.g., Note, *When a Security Becomes a Liability: Claims Against Lenders in Hazardous Waste Cleanup*, 35 HASTINGS L.J. 1261, 1273 (1987) (security interest exemption intended to exclude security interest holders from liability because they have only a tenuous connection to the hazardous waste site) [hereinafter *When a Security Becomes a Liability*]; Note, *Interpreting the Meaning of Lender Management Participation Under Section 101(20)(A) of CERCLA*, 98 YALE L.J. 925, 926 (1989) (security interest exemption intended to encourage banks to investigate potential lenders before lending and to encourage lenders to monitor borrower's activities during term of the loan) [hereinafter *Interpreting the Meaning of Lender Management Participation*].

32. See *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573 (D. Md. 1986); *United States v. Mirabile*, 15 Env'tl. L. Rep. (Env'tl. L. Inst.) 20994 (E.D. Pa. Sept. 4, 1985).

33. 632 F. Supp. 573 (D. Md. 1986).

34. CERCLA § 101(20)(A), 42 U.S.C. § 9601(20)(A) (Supp. V 1987).

the lender to recover \$551,713.50 in response costs.³⁵

Maryland Bank & Trust (MB&T) argued that, as a former mortgagee which had purchased the property at a foreclosure sale, it was exempt from liability under the security interest exemption of section 101(20)(A).³⁶ The court ruled, however, that the "exemption of subsection (20)(A) covers only those persons who, *at the time of the cleanup*, hold indicia of ownership to protect a then-held security interest in the land. . . . The mortgage held by MB&T (the security interest) terminated at the foreclosure sale . . . at which time it ripened into full title."³⁷

To reach this result, the court adopted a narrow interpretation of the purpose behind the security interest exemption. The court noted that in Maryland, a title theory state, the financial institution granting a mortgage holds title to the property while the mortgage is in effect. The court concluded that "Congress intended by this exception to exclude these common law title mortgagees from the definition of 'owner' since title was in their hands only by operation of the common law."³⁸

The court in *Maryland Bank & Trust* also appears to have reached this result because it felt that any other interpretation of the security interest exemption would result in a windfall to the lender.³⁹ If the exemption applied to a lender-turned-owner, the lender could purchase the property in its contaminated condition, allow the EPA to clean up the property using public funds, and then turn around and sell the newly unpolluted land at a substantial profit. In effect, the lender would be capturing the value of cleaning the property without having to pay for it.⁴⁰ The court reasoned that such an interpretation "would convert CERCLA into an insurance scheme for financial institutions, protecting them against possible losses due to the security of

35. *Maryland Bank & Trust*, 632 F. Supp. at 575-76.

36. *See id.* at 577.

37. *Id.* at 579 (emphasis added).

38. *Id.* A number of commentators have taken strong exception to this overly technical interpretation of the security interest exemption. *See, e.g.,* Burcat, *Environmental Liability of Creditors: Open Season on Banks, Creditors and Other Deep Pockets*, 103 BANKING L.J. 509, 534 (1986) ("Under the court's interpretation, only mortgagees in thirteen states have some limited protection. Presumably, mortgagees in other states and secured creditors holding security other than a mortgage have no protection under CERCLA. . . . This, clearly, is not the intent of Congress or CERCLA.").

39. *Maryland Bank & Trust*, 632 F. Supp. at 580; *see also* Guidice v. BFG Electrolating & Mfg. Co., No. 86-2093, slip op. at 18 (W.D. Pa. Sept. 1, 1989) (WESTLAW, Allfeds database) (In course of continuing case, district court denied lender's motion to dismiss, holding that "[w]hen a lender is a successful purchaser at a foreclosure sale, the lender should be liable to the same extent as any other at the sale would have been.").

40. *See Maryland Bank & Trust*, 632 F. Supp. at 580.

loans with polluted properties.”⁴¹ The court noted that financial institutions have the power to protect themselves from such losses by making prudent loans.⁴²

Despite the ruling in *Maryland Bank & Trust*, a lender that forecloses on a hazardous waste facility and then purchases the facility at the subsequent foreclosure sale may still argue that it is exempt from CERCLA liability on the basis that its conduct shows that its actions were taken purely to protect the lender's security interest in the property.⁴³

In *United States v. Mirabile*,⁴⁴ a federal district court ruled that a lender that had foreclosed on a hazardous waste disposal site and was the high bidder at the later foreclosure sale was entitled to the protection of the security interest exemption. The court granted the lender's motion for summary judgment on the basis that “its actions with respect to the foreclosure were plainly undertaken in an effort to protect its security interest in the property.”⁴⁵ Both before and after the foreclosure sale the lender had negotiated with other parties about purchasing the property. After the sale the lender made no attempt to continue the operations of the former owner which had contaminated the property with hazardous substances. The lender did, however, periodically visit the site for the purpose of showing it to prospective purchasers. In addition, the lender took steps to prevent the property from being vandalized.⁴⁶

Less than four months passed between the time the lender made the high bid for the property and the date when that bid was assigned to a third party.⁴⁷ The *Mirabile* court seems to have been especially influenced by the very short time the lender actually had control over the property. In contrast, the *Maryland Bank & Trust* court emphasized that a lender in a similar situation was not entitled to the secur-

41. *Id.*

42. *Id.* (“Financial institutions are in a position to investigate and discover potential problems in their secured properties. For many lending institutions, such research is routine.”).

43. *See United States v. Mirabile*, 15 Env'tl. L. Rep. (Env'tl. L. Inst.) 20994 (E.D. Pa. Sept. 4, 1985); *see also Maryland Bank & Trust*, 632 F. Supp. at 579 (court specifically stating that MB&T “purchased the property at the foreclosure sale not to protect its security interest, but to protect its investment”).

44. 15 Env'tl. L. Rep. (Env'tl. L. Inst.) 20994 (E.D. Pa. Sept. 4, 1985).

45. *Id.* at 20996.

46. *See id.*

47. *Id.* The lender also argued that its high bid at the foreclosure sale gave it only equitable title to the property because its subsequent assignment of the bid prevented the lender from ever acquiring full legal title. The court never reached this question, holding instead that, regardless of the nature of the title, the lender's actions indicated that it was seeking merely to protect its security interest. *Id.*

ity interest exemption when "the former mortgagee has held title for nearly four years, and a full year before the EPA cleanup."⁴⁸

Mirabile thus demonstrates the limits of the security interest exemption. When the lender does not hold the property for a significant period of time and does not operate the property in a way that contributes to the existing contamination, it may be able to sell the property without incurring liability for CERCLA response costs.

B. The Lender as "Operator"

The security interest exemption of section 101(20)(A)⁴⁹ is not a blanket exemption for all holders of security interests. When a lender "holds indicia of ownership primarily to protect his security interest"⁵⁰ but also "participat[es] in the management"⁵¹ of the secured property, the lender will be deemed to be an "owner or operator" for purposes of CERCLA liability.⁵² The *Mirabile* court was the first to attempt to define what actions by a lender constitute participating in the management of a facility.⁵³

Mirabile was a suit by EPA to recover response costs for cleaning up a hazardous waste disposal site which, at the time of the cleanup, was owned by Anna and Thomas Mirabile. The Mirabiles joined two lending institutions, American Bank and Trust Company (ABT) and Mellon Bank (East) National Association (Mellon), as third-party defendants. Both ABT and Mellon had provided financing to the former owner who had operated a paint manufacturing business on the site at the time the hazardous contamination occurred. ABT and Mellon both filed motions for summary judgment claiming protection under the section 101(20)(A) security interest exemption.⁵⁴

As discussed previously, ABT, which had actually foreclosed on the property and was the high bidder at the subsequent foreclosure sale, was granted summary judgment because the court found that it

48. *Maryland Bank & Trust*, 632 F. Supp. at 579. The court distinguished *Mirabile* on the basis of this time differential, stating: "Because MB&T has held the property for such an extended period of time, this Court need not consider the issue of whether a secured party which purchased the property at a foreclosure sale and then promptly resold it would be precluded from asserting the section 101(20)(A) exemption." *Id.* at n.5.

49. CERCLA § 101(20)(A), 42 U.S.C. § 9601(20)(A) (Supp. V 1987).

50. *Id.*

51. *Id.*

52. *Id.*

53. See *United States v. Mirabile*, 15 Env'tl. L. Rep. (Env'tl. L. Inst.) 20994, 20996-97 (E.D. Pa. Sept. 4, 1985).

54. *Id.* at 20994-95.

had merely acted to protect its security interest in the property.⁵⁵ The court declined to grant Mellon's motion for summary judgment on the basis that there existed "a genuine issue of fact as to whether Mellon Bank . . . engaged in the sort of participation in management which would bring a secured creditor within the scope of CERCLA liability."⁵⁶

The court began its interpretation of the security interest exemption by noting that the exemption "plainly suggests that provided a secured creditor does not become overly entangled in the affairs of the actual owner or operator of a facility, the creditor may not be held liable for cleanup costs."⁵⁷ Thus, the problem with interpreting section 101(20)(A) was "in determining how far a secured creditor may go in protecting its financial interests before it can be said to have acted as an owner or operator within the meaning of the statute."⁵⁸

The court ultimately concluded that the security interest exemption evidenced the intent of Congress "to draw a distinction between parties involved in the actual operation of the facility and those who are involved in what may properly be characterized as the financial aspects of the business conducted at the facility"⁵⁹ The court ruled that a secured creditor's mere financial ability to control waste disposal practices was not sufficient for the imposition of liability.⁶⁰ Instead, "before a secured creditor . . . may be held liable, it must, at a minimum, participate in the day-to-day operational aspects of the site."⁶¹ Because some evidence existed that Mellon had become involved in the day-to-day operations of its borrower, the court reluctantly denied Mellon's motion for summary judgment.⁶²

The *Mirabile* court failed to define adequately what actions by a creditor constitute "participating in management" such that the creditor will subject itself to CERCLA liability. The court indicated that some financial activities—such as monitoring the borrower's cash collateral accounts, ensuring that receivables went to the proper account, and establishing a reporting system between the borrower and the lender—would not subject the lender to CERCLA liability.⁶³ The court, however, also indicated that some steps a financial institution normally would take to assist a troubled borrower could subject the

55. See *supra* notes 43-46 and accompanying text.

56. *Mirabile*, 15 Env'tl. L. Rep. at 20997.

57. *Id.* at 20995.

58. *Id.*

59. *Id.* at 20995-96.

60. *Id.* at 20995.

61. *Id.* at 20996.

62. See *id.* at 20997.

63. See *id.*

lender to CERCLA liability. These potentially dangerous actions include conditioning the borrower's continued credit on its acceptance of day-to-day supervision by the lender. The court also indicated that the interjection of advice by a lender on such matters as the borrower's personnel or production practices could subject the lender to CERCLA liability.⁶⁴ Beyond these very basic guidelines, "participating in management" remains undefined.

The issue of lender liability recently was revisited in *United States v. Fleet Factors Corp.*⁶⁵ Unlike *Mirabile*, in which private parties were attempting to implead their lenders, *Fleet Factors* involved an attempt by EPA to expand the concept of "owner or operator." Because the lender never foreclosed on the real property, there was no question as to whether the lender was a present "owner" of the property. Instead, the case centered on the EPA's contentions that the lender was an "operator" of the facility at the time of disposal of hazardous substances.

First, the EPA contended that the lender was an "operator" of the facility because it had participated in the business operations of the former owner of the site prior to bankruptcy. During this period, the lender's involvement in the operations of the debtor had been limited to approving customer's credit prior to shipment and receiving a portion of the sales proceeds to be applied against the outstanding indebtedness. Noting that this was normal practice for a secured lender under a factoring arrangement, the court adopted the interpretation of the lender liability exclusion established in *Mirabile*, stating that the exclusion permits "secured creditors to provide financial assistance and general, and even isolated instances of specific, management advice to its debtors without risking CERCLA liability if the secured creditor does not participate in the day-to-day management of the business or facility either before or after the business ceases operation."⁶⁶

Second, the EPA claimed that the lender became an "operator" during the liquidation because its agents or representatives released hazardous substances in the course of the auction and removal of the inventory and equipment. There was evidence that the auctioneer had moved leaking drums of chemicals from the sales area, causing some spillage, and that some of the purchasers had dislodged asbestos in removing equipment they had purchased. The court held that this evidence presented a genuine issue of material fact with respect to whether the lender was an operator of the property at the time of dis-

64. *See id.*

65. 724 F. Supp. 955 (S.D. Ga. 1988).

66. *Id.* at 960.

posal of hazardous substances.⁶⁷

The magnitude of the liabilities at stake for lenders is illustrated by *Grantors to the Silresim Site Trust v. State Street Bank & Trust Co.*,⁶⁸ a case recently filed in Massachusetts.⁶⁹ In *State Street Bank* a group of some 200 companies has filed suit against a lender for the entire \$30 to \$50 million cost of cleaning up a hazardous waste treatment site operated by the Silresim Chemical Corporation. The plaintiffs allege that a consultant hired by the lender to help manage the site and protect its interests exercised effective control over the day-to-day operation of Silresim and that the lender was, therefore, an "operator" of the facility and is liable for the costs of cleanup.⁷⁰

C. Individual Liability of the Lender's Corporate Officers and Directors

The security interest exemption also must be interpreted with reference to earlier decisions that held that corporate officers⁷¹ and stockholders⁷² may be held individually liable under CERCLA. These decisions, read in light of *Mirabile*, indicate that lenders should be especially wary of placing their corporate officers on the boards of troubled borrowers and accepting shares of the borrower's stock if the lender subsequently will become involved in the day-to-day operations of the borrower.

In *United States v. Carolawn*⁷³ a federal district court read the security interest exemption as showing that "CERCLA contemplates personal liability of corporate officials . . . who are responsible for the day-to-day operations of a hazardous waste disposal business."⁷⁴ The court went on to rule that "to the extent that an individual has control or authority over the activities of a facility from which hazardous substances are released or participates in the management of such a facility, he may be held liable for response costs incurred at the facility

67. *Id.* at 960-61.

68. No. 88-1324-k (D. Mass. filed Sept. 21, 1988).

69. See Mays, *Secured Creditors and Superfund: Avoiding the Liability Net*, 20 *Env't. Rep. (BNA)* 609, 613 (July 28, 1989).

70. *See id.*

71. *See, e.g., United States v. Northeastern Pharmaceutical & Chem. Co.*, 579 F. Supp. 823, 847-48 (W.D. Mo. 1984), *aff'd in part, rev'd in part*, 810 F.2d 726 (8th Cir. 1986), *cert. denied*, 484 U.S. 848 (1987); *United States v. Carolawn Co.*, 14 *Env'tl. L. Rep. (Env'tl. L. Inst.)* 20699, 20700 (D.S.C. June 15, 1984).

72. *New York v. Shore Realty Corp.*, 759 F.2d 1032, 1052 (2d Cir. 1985) (security interest exemption "implies that an owning stockholder who manages the corporation . . . is liable under CERCLA as an 'owner or operator'").

73. 14 *Env'tl. L. Rep. (Env'tl. L. Inst.)* 20699 (D.S.C. June 15, 1984).

74. *Id.* at 20700.

notwithstanding the corporate character of the business.”⁷⁵ Under this reasoning, a corporate officer or employee of a lender who was placed on the board of a troubled borrower in order to oversee its financial affairs could be held personally liable for CERCLA response costs.

Similarly, in *New York v. Shore Realty Corp.*⁷⁶ the Second Circuit ruled that a corporate officer and stockholder who was responsible for the continuing release of a hazardous substance could be held individually liable for CERCLA response costs. The court implied that the stockholder was an “owner or operator” of the facility because his stock holdings could be seen as indicia of ownership. The security interest exemption did not apply to the stockholder because he had actively participated in the management of the facility.⁷⁷ The same reasoning would apply to a lender that accepted corporate stock from a troubled borrower and subsequently became “overly entangled in the affairs” of the corporation.⁷⁸

Issues relating to stockholder liability also arise in the context of piercing the corporate veil between a parent and subsidiary. In such cases, the government has urged the adoption of a uniform federal rule on parent corporation liability.⁷⁹ The rule suggested by the government constitutes a significant change from federal common law and would hold a parent corporation liable either when the subsidiary is integrated in some substantial way into the business enterprise conducted by the parent, or when the parent directly participated in the management of the subsidiary.⁸⁰ As justification for this change, the government argues that the revised rule would better promote the purposes for which CERCLA was enacted, and cites the general federal rule that the corporate form may be ignored for public convenience, fairness and equity.⁸¹

The response of federal courts to this suggested expansion of parent corporation liability has varied. In *Joslyn Manufacturing Co. v. T.L. James & Co.*⁸² a Louisiana federal district court held that, in the absence of an express congressional directive to the contrary, the traditional federal test applies.⁸³ Arguing for liability of the parent corpora-

75. *Id.*

76. 759 F.2d 1032 (2d Cir. 1985).

77. *Id.* at 1052.

78. See *United States v. Mirabile*, 15 Env'tl. L. Rep. (Env'tl. L. Inst.) 20994, 20995 (E.D. Pa. Sept. 4, 1985).

79. Brief of United States as Amicus Curiae at 19, *Joslyn Mfg. Co. v. T.L. James & Co.*, 696 F. Supp. 222 (D. La. 1988) (No. 88-4901), *aff'd*, 893 F.2d 80 (5th Cir. 1990).

80. See *id.*

81. *Id.* at 16-17.

82. 696 F. Supp. 222 (D. La. 1988), *aff'd*, 893 F.2d 80 (5th Cir. 1990).

83. *Id.* at 226.

tion, the plaintiff in *Joslyn* pointed to common stock ownership, shared directors, substantial loans (which were later repaid) from the parent for the initial capitalization, and shared office facilities. The court, however, noted that the subsidiary corporation strictly adhered to basic corporate formalities by keeping its own books and records, holding periodic shareholder and director meetings, ensuring that the daily operations of the two corporations were separate, maintaining separate ownership of property, paying employees of the subsidiary from nonparent funds and filing separate income tax returns.⁸⁴ Accordingly, the court held that the facts alleged by the plaintiff did not show such "total domination" of the subsidiary that the subsidiary could be said to have "no separate corporate interest of its own and [to have] functioned solely to achieve the purposes" of the parent.⁸⁵ Thus, the court ruled that, as a matter of law, the facts proved were insufficient to justify piercing the corporate veil.⁸⁶

The result in a recent case in the federal district court in Rhode Island was quite different. In *United States v. Kayser-Roth Corp.*⁸⁷ the court found the parent corporation liable "not only because public convenience, fairness, and equity dictate[d] such a result, but also due to the all encompassing control which [the parent] had over [the subsidiary]"⁸⁸ The precise meaning of this holding is unclear. Although there is language in the court's opinion that appears to endorse the government's position, the court actually applied the traditional federal test in finding that the corporate form should be ignored. Thus, the court cited the following factors in support of its holding: (1) the parent's complete control of the day-to-day financial operations of the subsidiary; (2) the parent's directive that contacts between the subsidiary and the government (including contacts on environmental matters) be handled by the parent; (3) the parent's requirement that all matters relating to the subsidiary's leasing, buying, or selling of real estate and to capital expenditures over \$5,000 first be approved by the parent; and (4) the parent's placement of its personnel in almost all director and officer positions in the subsidiary.⁸⁹

IV. THE INNOCENT LENDER DEFENSE

The court decisions in *Maryland Bank & Trust*, *Mirabile* and

84. *Id.* at 231.

85. *Id.* at 227.

86. *Id.* at 231-32.

87. 724 F. Supp. 15 (D.R.I. 1989).

88. *Id.* at 24.

89. *Id.* at 22.

Shore Realty all were rendered prior to the passage of the Superfund Amendments and Reauthorization Act of 1986 (SARA).⁹⁰ Accordingly, the defendants in those cases were unable to avail themselves of an affirmative defense which SARA added to CERCLA.

Section 107(b)(3) of CERCLA provides a complete defense for defendants who can show that the release or threatened release of a hazardous substance and the resulting damage were caused *solely* by

an act or omission of a third party other than an employee or agent of the defendant, or than one whose act or omission occurs in connection with a contractual relationship, existing directly or indirectly, with the defendant . . . if the defendant establishes by a preponderance of the evidence that (a) he exercised due care with respect to the hazardous substance . . . and, (b) he took precautions against foreseeable acts or omissions of any such third party and the consequences that could foreseeably result from such acts or omissions⁹¹

Accordingly, in order to take advantage of this third-party defense, a defendant must establish the following factors: (1) that the contamination on the property was caused solely by a third party; (2) that the actions of the third party did not occur in connection with any direct or indirect contractual relationship between the third party and the defendant; and (3) that the defendant took due care in preventing or mitigating the contamination.

A major issue under CERCLA prior to the passage of SARA was whether a current owner could claim that a prior owner was solely responsible for any contamination and thereby invoke the section 107(b)(3) defense. This issue usually became a question of whether the deed or other instrument conveying the property from the prior owner to the current owner was a "contract" for purposes of the section 107(b)(3) defense. SARA attempted to resolve this question by amending CERCLA to define the term "contractual relationship" as it was used in section 107(b)(3).⁹²

Section 101(35)(A) defines a contractual relationship in such a way that any deed or other instrument conveying title or possession to real property will be considered a contract *unless* the acquiring party did not know or have any reason to know that hazardous substances had been disposed of on the property.⁹³ This definition of "contractual relationship," while actually an additional requirement to establishing a section 107(b)(3) defense, became known as the innocent landowner

90. See *supra* note 14.

91. CERCLA § 107(b)(3), 42 U.S.C. § 9607(b)(3) (1982 & Supp. V 1987).

92. See *supra* note 23 and accompanying text.

93. CERCLA § 101(35)(A), 42 U.S.C. § 9601(35)(A) (Supp. V 1987).

defense.⁹⁴

In order to establish an innocent landowner defense, a defendant must, at the time of purchase, have undertaken an "appropriate inquiry" into the previous uses of the property.⁹⁵ In deciding whether a purchaser has conducted an appropriate inquiry, section 101(35)(B) instructs courts to take into account any expertise possessed by the defendant, the actual purchase price of the property as compared to the value of the property if uncontaminated, any reasonably available information about the property, the obviousness of the contamination, and whether an appropriate inspection of the property would have detected the presence of contamination.⁹⁶

While section 101(35)(B) only modifies the third-party defense of section 107(b)(3), it in effect codifies a general due diligence standard for all persons involved in real estate transactions. In order to be free of potential liability for CERCLA cleanup costs, a purchaser of real estate must comply with all the requirements of the third-party defense under section 107(b)(3) *and* all the requirements of the innocent landowner defense under section 101(35)(b).⁹⁷

Questions about how the innocent landowner defense would be implemented were raised soon after SARA was passed.⁹⁸ On June 6, 1989, the EPA released a long-awaited guidance document on landowner liability under CERCLA.⁹⁹ Unfortunately, the guidance document sheds little light on what steps a prospective purchaser must take to conduct the appropriate inquiry required by section 101(35)(B).¹⁰⁰ Legislation currently pending in Congress would amend section 101(35) to provide a specific definition of what steps are required to satisfy the "all appro-

94. See Note, *When a Security Becomes a Liability*, *supra* note 31, at 1269.

95. CERCLA § 101(35)(B), 42 U.S.C. § 9601(35)(B) (Supp. V 1987).

96. *Id.*

97. Comment, *The Liability of Financial Institutions for Hazardous Waste Cleanup Costs Under CERCLA*, 1988 Wis. L. Rev. 139, 156-58; Note, *When a Security Becomes a Liability*, *supra* note 31, at 1268-69.

98. See *Issues in Instituting Revised Superfund Law Remain Unresolved, According to CMA Attorney*, 17 Env't Rep. (BNA) 1480-81 (Dec. 26, 1986) ("How the innocent landowner defense will work and how using the defense will affect real estate transactions need to be determined . . .").

99. See UNITED STATES ENVIRONMENTAL PROTECTION AGENCY, GUIDANCE ON LANDOWNER LIABILITY UNDER SECTION 107(A)(1) OF CERCLA, DE MINIMIS SETTLEMENTS UNDER SECTION 122(Q)(1)(B) OF CERCLA, AND SETTLEMENTS WITH PROSPECTIVE PURCHASERS OF CONTAMINATED PROPERTY (June 6, 1989) [hereinafter GUIDANCE ON LANDOWNER LIABILITY].

100. See generally O'Brien, *EPA's Landowner Liability Guidance Unsatisfactory for Lenders and Purchasers*, 53 Banking Rep. (BNA) 169, 169 (July 31, 1989) ("There is little 'guidance' in the guidance, however, as to what constitutes all appropriate inquiry.").

appropriate inquiry" requirement.¹⁰¹ Until such legislation is adopted, the innocent landowner defense is of little use to prospective purchasers and their lenders.

V. AVOIDING THE LENDER TRAP

Based on the foregoing discussion, it is clear that no authority exists telling lenders precisely how to avoid CERCLA liability. Nonetheless, some basic principles for avoiding CERCLA lender liability can be distilled from existing case law. First, the lender should perform an environmental audit before making any loan upon potentially contaminated property. The results of this audit will permit the lender to make an informed judgment regarding the risk of incurring CERCLA liability, which can then be factored into the lending decision.

Second, the lender should minimize participation in the borrower's business or ownership of the property. The lender should carefully assess the risks created by equity participation, rights of control instructions regarding business operations, approval of expenditures and other management decisions, and the myriad of other "standard" provisions which entangle the lender with the borrower's waste disposal practices, even indirectly.

Third, upon default, the lender should carefully weigh the risks inherent in a foreclosure. The lender should investigate the borrower's waste handling practices, consider a pre-foreclosure environmental audit, and carefully weigh any instructions or decisions (such as the cut-off of further funds) for their potential contribution to CERCLA liability.

Fourth, upon foreclosure, the lender should take every step to liquidate the property as promptly as possible, avoiding the exercise of all indicia of ownership. The lender should consider a pre-foreclosure Deed in Lieu of Foreclosure to a third-party purchaser, Chapter 11 reorganization, a workout or other alternative to directly taking title so as to avoid becoming the owner of a hazardous waste site.

Finally, upon becoming owner of a hazardous waste site, the lender should move swiftly to develop a strategy for resolving the environmental problems with the state and federal government. Only in ex-

101. See H.R. 2787, 101st Cong., 1st Sess. (1989). The Innocent Landowner Defense Amendments of 1989 would establish a rebuttable presumption that a purchaser has satisfied the "all appropriate inquiry" requirement of section 101(35)(B) if the prospective purchaser carried out "an investigation into [the following] three general areas regarding the environmental condition of [the] real estate: (1) historical research into previous ownership and uses; (2) a comprehensive governmental records review at the Federal, State, and local level; and (3) a site investigation of the property and its improvements." 135 CONG. REC. E2367-68 (daily ed. June 28, 1989) (statement of Rep. Weldon).

treme cases will the lender benefit from extended litigation with the government and, in any event, this course should be the choice of the lender who has carefully thought out a CERCLA liability strategy.

Although the cases and statutes cited in this Article give some broad guidance with respect to CERCLA lender liability, they are most remarkable for the questions they leave unanswered. The remainder of this Article addresses unresolved questions in CERCLA lender liability.

A. *After Mirabile, What Constitutes "Participating in the Management" of a Hazardous Waste Disposal Facility?*

Mirabile has raised more questions than it has answered with regard to what will be considered participating in the management of a hazardous waste facility. The only distinct rule which emerges from *Mirabile* is that merely providing general financial advice will not be considered participating in management.¹⁰² Thus, under *Mirabile*, actions a lender normally would take to assist a troubled borrower may be construed as participating in the management of the borrower's business.¹⁰³

Future cases will decide what actions constitute the kind of participation in the management of the borrower's business necessary to impose CERCLA liability upon the lender. Any such rule must remain faithful to the underlying goal of CERCLA's liability scheme: to allocate the cost of cleanup among those who contributed to the problem. One way that this goal could be served would be to define "participating in management" by looking to the developing law under CERCLA regarding when a shareholder will be held personally liable for the actions of the corporation. Those cases have imposed liability on shareholders only when the shareholders had been truly active in the day-to-day operations of the corporation *and* were directly involved in decisions regarding the handling or disposal of hazardous waste.¹⁰⁴ The

102. See *United States v. Mirabile*, 15 Env'tl. L. Rep. (Env'tl. L. Inst.) 20994, 20995-96 (E.D. Pa. Sept. 4, 1985). The court did specifically state that certain types of day-to-day financial operations would not give rise to CERCLA liability. These specific activities "includ[e] monitoring the cash collateral accounts, ensuring that receivables [go] to the proper account, and establishing a reporting system between the company and the bank." *Id.* at 20997.

103. For example, one of the reasons the court felt that Mellon may have participated in management was that it placed a bank employee on an advisory board designed to steer the borrower through difficult financial straits. *Id.*

104. See *New York v. Shore Realty Corp.*, 759 F.2d 1032, 1037-39, 1052-53 (2d Cir. 1985) (stockholder who managed corporation which bought hazardous waste storage site made conscious decision not to clean up leaking drums of hazardous waste); *United States v. Carolawn Co.*, 14 Env'tl. L. Rep. (Env'tl. L. Inst.) 20699, 20699-700 (D.S.C. June

Mirabile court looked to these cases, but concluded that they “provide only limited guidance . . . because in each case the individual defendants were extremely active in the affairs of closely held corporations.”¹⁰⁵ But that is precisely the point: those who are directly involved in deciding how to dispose of hazardous waste should be held liable if those decisions lead to environmental contamination.

Under this reasoning lenders would be “participating in management” only if they directly control the borrower’s waste disposal practices. If lenders control these decisions and choose inadequate disposal methods, then they should be held liable for the consequences. If the lender does not control these decisions, however, but merely advises the borrower about cutting costs or streamlining operations in an environmentally sound matter, the lender should not be held liable for environmental contamination it did not cause.

This approach would be consistent with existing principles of commercial law governing when a lender, due to his influence and authority over the borrower, may become liable for *all* the borrower’s debts.¹⁰⁶ Under the alter ego (instrumentality) rule, a lender may become liable for all of the debts of its borrower only if it has “assumed actual, participatory and total control” over the borrower.¹⁰⁷ Similarly, the doctrine of equitable subordination allows a lender’s claims against his borrower to be subordinated to those of other creditors if the lender’s control over the borrower amounted to domination of the debtor’s will.¹⁰⁸

The “total control” test for interpreting what constitutes “participating in management” is appropriate for a number of reasons. It would serve the goal of CERCLA by imposing liability on lenders who become “overly entangled” in the affairs of their borrowers, while at the same time insulating from liability those lenders who are not di-

15, 1984) (individuals were owners and officers in closely-held corporation which disposed of hazardous waste); *United States v. Northeastern Pharmaceutical & Chem. Co.*, 579 F. Supp. 823, 847-48 (W.D. Mo. 1984) (vice president of hazardous waste generator was directly responsible for arranging the disposal and transport of the hazardous waste), *aff’d in part, rev’d in part*, 810 F.2d 726 (8th Cir. 1986), *cert. denied*, 484 U.S. 848 (1987).

105. *Mirabile*, 15 Env’tl. L. Rep. at 20995.

106. Several commentators have argued persuasively that lender liability under CERCLA should be interpreted with reference to the analogous body of commercial law governing lender liability. See Burcat, *supra* note 38, at 528-31; Note, *Interpreting the Meaning of Lender Management Participation*, *supra* note 31, at 934-43.

107. *Krivo Indus. Supply Co. v. National Distillers & Chem. Corp.*, 483 F.2d 1098, 1105 (5th Cir. 1973); see Burcat, *supra* note 38, at 528-30; Note, *Interpreting the Meaning of Lender Management Participation*, *supra* note 31, at 941-43.

108. See Note, *Interpreting the Meaning of Lender Participation*, *supra* note 31, at 937-41.

rectly responsible for environmental contamination.¹⁰⁹ Moreover, using existing principles of commercial law to interpret the meaning of "participating in management" would be consistent with basic rules of statutory construction which hold that statutes should be construed with reference to the common law as it existed at the time the statute was adopted.¹¹⁰

Finally, these principles of debtor/creditor commercial law have been in use long enough that lenders can determine which specific practices may expose them to liability for having participated in management. In order to avoid liability under CERCLA, lenders should not: (1) assume complete management of the borrower; (2) obtain or utilize the right to have a third party assume management control over the borrower; (3) make payments on behalf of the borrower to other creditors; (4) determine the priority and/or timing of payments to other creditors; (5) require the borrower to obtain the lender's consent before making any bonus or dividend payments; (6) require that the lender co-sign all of the borrower's checks; (7) require that the lender approve all of the borrower's purchases; or (8) obtain or exercise veto power over the borrower's business decisions.¹¹¹

The use of these basic principles of commercial law to establish recognizable standards of liability will allow lenders to operate with reasonable expectations about their potential liability under CERCLA.

B. When, if Ever, Can a Lender Who Forecloses Take Advantage of the Innocent Landowner Defense?

A lender holding a security interest in property which may be contaminated with hazardous wastes has few options if the borrower goes into default. The lender may attempt to avoid any possibility of CERCLA liability by deciding not to foreclose and merely write off the unpaid balance of the loan as a loss. Alternatively, the lender may foreclose on the property but not bid at the foreclosure sale and hope that some third party willing to shoulder any possible cleanup costs will purchase the site. Finally, the lender may foreclose on the property, purchase the site at the foreclosure sale, take title to the property and

109. As stated by one commentator, "the court should find that total control amounting to ownership is what exposes the creditor to liability. Liability should be triggered not just by nominal activities that appear to give creditors management or voting control, but rather by actual exercise of such control that amounts to coercion, and, in effect, actual ownership." *Id.* at 943.

110. See Burcat, *supra* note 38, at 532-33.

111. See Burcat, *supra* note 38, at 537-38; King, *Lenders' Liability for Cleanup Costs*, 18 ENVTL. L. 241, 290-91 (1988).

attempt to establish the third-party/innocent landowner defense.¹¹²

In deciding among these options, lenders should take pains to determine the value of the security in both its contaminated and unpolluted states. If the likelihood of significant contamination is low and the value of the site in its unpolluted condition is relatively high, it may well make sense for the lender to take title to the property, incur the cleanup costs and sell the property for a profit. Alternatively, a lender may seek to complete a profitable transaction by assuming title and avoiding CERCLA liability by establishing an innocent landowner defense.

As discussed above,¹¹³ the innocent landowner defense is very difficult to establish. Essentially, the purchaser has to show that it made "all appropriate inquiry" into the previous ownership and uses of the property to establish that the purchaser "did not know and had no reason to know that any hazardous substance[s] [had been] disposed of on [the property]."¹¹⁴ The problem is that, four years after the innocent landowner defense was created by SARA, there is no general agreement as to what steps are necessary to satisfy the "all appropriate inquiry" requirement.

Since SARA, the typical approach in the lending industry has been to conduct a Phase I Environmental Audit of the property.¹¹⁵ Unfortunately, there is no agreement within the industry as to what a Phase I Environmental Audit includes. Different federal loan guarantee agencies have established different standards.¹¹⁶ A definitive standard for conducting a Phase I Environmental Audit is desperately needed.¹¹⁷

Legislation currently pending in Congress would codify the requirements for a Phase I Environmental Audit sufficient to establish that the prospective purchaser has made "all appropriate inquiry" necessary to invoke the innocent landowner defense.¹¹⁸ The bill, introduced on June 28, 1989, by Pennsylvania Representative Curt Weldon, would require a five part-investigation: (1) a review of recorded chain

112. Comment, *supra* note 97, at 177.

113. See *supra* notes 90-101 and accompanying text.

114. CERCLA § 101(35), 42 U.S.C. § 9601(35) (Supp. V 1987).

115. O'Brien, *supra* note 100, at 171.

116. Compare FEDERAL NATIONAL MORTGAGE ASSOCIATION, ENVIRONMENTAL HAZARDS MANAGEMENT PROCEDURES (August 1, 1988) with FEDERAL HOME LOAN BANK BOARD, THRIFT BULLETIN 16: ENVIRONMENTAL RISK AND LIABILITY (February 6, 1989).

117. See O'Brien, *supra* note 100, at 170 ("The source of concern in the financial markets has been the absence of some established standard. . . . Lenders and purchasers need certainty in the quantification of risks involved in a transaction.").

118. The Innocent Landowner Defense Amendment of 1989, H.R. 2787, 101st Cong., 1st Sess. (1989).

of title documents for a period of fifty years; (2) a review of aerial photographs of the site if such photographs are reasonably obtainable from state or local government agencies; (3) a search of federal, state and local records to determine whether any environmental cleanup liens have been placed on the property; (4) a search of reasonably obtainable federal, state and local government records to determine whether the property has been associated with incidents or activities likely to have caused contamination; and (5) a visual site inspection of the property and any immediately adjacent properties.¹¹⁹

Noticeably absent from the Weldon bill is any requirement for on-site sampling for hazardous wastes. The inclusion of such a requirement, however, would resolve one major problem which has faced lenders: whether expensive environmental sampling is a prerequisite to establishing an innocent landowner defense.¹²⁰

The Weldon bill does not specifically distinguish between commercial and residential transactions, but Representative Weldon's introductory statement indicates that the amendment is intended to govern only commercial sales.¹²¹ This is consistent with EPA's recent guidance on landowner liability and is a realistic approach to the different levels of sophistication involved in the different transactions.¹²²

The specific details of the Weldon bill will and should be debated,¹²³ but the bill at least represents an attempt to establish reasonable standards so that lenders will be able to predict with some level of certainty the risks they face in financing the acquisition of real property.

Even if a lender can establish the innocent landowner defense under section 101(35)(B), still it must meet the other requirements of the third-party defense: that it exercised due care with respect to any

119. H.R. 2787, 101st Cong., 1st Sess. at 2-4.

120. See O'Brien, *supra* note 100, at 171 ("Whether 'punching holes' is always part of 'all appropriate inquiry' has been, and continues to be, the most troublesome issue in environmental due diligence.").

121. See 135 CONG. REC. E2367-68 (daily ed. June 28, 1989) (statement of Rep. Weldon). Representative Weldon argued:

"The congressional intent regarding the current legislation clearly distinguishes between commercial transactions and private, residential transactions. The EPA Guidance on Landowner Liability and the case law addressing the issue have also realized that commercial transactions are held to a higher standard and that it is appropriate that parties to commercial transactions look before they buy or lend on commercial properties."

Id. at E2368.

122. See GUIDANCE ON LANDOWNER LIABILITY, *supra* note 99, at 11-12; O'Brien, *supra* note 100, at 172-73.

123. If a 50-year title search is good, might a 75-year title search be better? Should sampling be a requirement of a Phase I Environmental Audit?

hazardous substances and took precautions against the foreseeable acts or omissions of any third parties.¹²⁴ This always will depend on the facts of each given situation, but a lender who takes title to property which may be contaminated with hazardous wastes can take steps to maximize its chances of meeting the requirements of the third-party defense.

As the court in *Mirabile* indicated, one major step a foreclosing lender can take is to secure the property to prevent vandalism.¹²⁵ Such a simple action, which often is normal procedure in such situations, certainly will help show that the lender fulfilled its duty to protect against the actions of third parties. Similarly, a lender can show that it is exercising due care by cooperating with any local, state or federal investigation to determine whether hazardous wastes are present on the property.

C. The Toughest Issue: How Long May A Lender Own Contaminated Property and Still Avoid CERCLA Liability?

The length of time a lender who forecloses on contaminated property may own the property before incurring CERCLA liability is a point on which a sharp contrast can be drawn with respect to the decisions in *Mirabile* and *Maryland Bank & Trust*. *Mirabile* held that a lender who sold off contaminated property within four months of acquiring it was entitled to the protection of the security interest exemption of section 101(20)(A).¹²⁶ At the other extreme, *Maryland Bank & Trust* held that a lender who retained ownership of contaminated property for nearly four years was not entitled to the exemption.¹²⁷ Although other factors certainly entered into the court's calculations, the length of time title was held was undoubtedly a major factor in the opposite outcome of the two cases.

What is the liability of a lender that forecloses on mortgaged property, later purchases it at the foreclosure sale, never operates the facility, but owns it for more than four months but less than four years? A court when faced with this situation most likely will attempt to minimize the significance of *Mirabile*. The case is highly susceptible to being limited to its facts. In *Mirabile*, American Bank & Trust apparently never actually took legal title to the site. The bank made the high

124. See CERCLA § 107(b)(3)(a)-(b), 42 U.S.C. § 9607(b)(3)(a)-(b) (1982 & Supp. V 1987).

125. *United States v. Mirabile*, 15 Env'tl. L. Rep. (Env'tl. L. Inst.) 20994, 20996 (E.D. Pa. Sept. 4, 1985).

126. *Id.*

127. *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573, 579 (D. Md. 1986).

bid at the foreclosure sale, but assigned this bid to the Mirabiles four months later. The court never addressed the issue of whether this action prevented the bank from acquiring legal title.¹²⁸ A court confronted with a situation in which there is no doubt that the lender has full legal title to the contaminated property, regardless of the length of time the lender held title, could readily find *Mirabile* inapposite and impose CERCLA liability on the lender. This result is especially likely since courts have indicated that such liability may be imposed on persons who have held legal title to contaminated property for as little as one hour.¹²⁹

D. May a Lender Be Liable for CERCLA Response Costs Incurred After it Sells Foreclosed Property?

As originally drafted, CERCLA imposed liability only on the current owner of a hazardous waste disposal site and any person who owned the facility at the time hazardous wastes were disposed of there.¹³⁰ SARA, however, added another provision which could be used to impose liability on a lender who forecloses on contaminated property and later sells it to a third party.

Section 101(35)(C) provides that a former owner may be held liable for subsequent CERCLA response costs even though the former owner did not own the property during disposal and is not the current owner, if the former owner obtained actual knowledge of the contamination when it owned the property and did not disclose this fact to the subsequent purchaser.¹³¹ Moreover, a former owner failing to disclose this information at the time of sale would be unable to use the third-party defenses provided by section 107(b)(3).¹³²

This provision may expand significantly the potential liability of lenders who foreclose on contaminated property. If a lender were to take all the steps necessary to conduct the "appropriate inquiry" needed to establish the innocent landowner defense and find the presence of some contamination, not only would the lender lose the defense, but it also would be under an affirmative duty to disclose the contamination to any prospective purchasers. The practical effect of this provision is that lenders who foreclose on property with the inten-

128. See *Mirabile*, 15 Env'tl. L. Rep. at 20996.

129. See *United States v. Carolawn Co.*, 14 Env'tl. L. Rep. (Env'tl. L. Inst.) 20698 (D.S.C. June 15, 1984) (firm which acted as a conduit in the transfer of title to a hazardous waste disposal site and held legal title to the site for less than one hour could be an "owner" for purposes of CERCLA).

130. CERCLA § 107(a)(1)-(2), 42 U.S.C. § 9607(a)(1)-(2) (1982) (amended 1986).

131. CERCLA § 101(35)(C), 42 U.S.C. § 9601(35)(C) (Supp. V 1987).

132. See *id.*

tion of selling it as quickly as possible may instead become owners in perpetuity.

E. The Lender as a De Minimis Party

A lender who incurs liability under CERCLA should nevertheless examine the prospect of de minimis treatment. Although conceptually the de minimis provisions of SARA and the EPA's settlement policy are aimed at those whose contribution to the volume of waste at a site is small and negligibly toxic, the provisions also provide an important middle ground for the lender that is strictly liable under CERCLA's scheme, but is less culpable than the major generators at the site.

Section 122(g)(1)(B) of SARA¹³³ allows the government to enter into a final settlement with a potentially responsible party if the settlement involves only a minor portion of the response costs at the relevant facility, the potentially responsible party's contribution of hazardous substances to the facility was minimal in comparison to other hazardous substances disposed of there, and the toxic effects of the wastes contributed by the potentially responsible party are minimal compared to other wastes disposed of at the site.¹³⁴

The de minimis settlement provision is especially useful to lenders because it is only available to potentially responsible parties who are owners of the hazardous waste disposal facility, did not conduct or permit the disposal of hazardous wastes at the facility, and did not contribute to the release of wastes through any act or omission.¹³⁵ The settlement is not available to any potentially responsible person who had actual or constructive knowledge that the property was used for the disposal of hazardous wastes.¹³⁶

The EPA's landowner liability guidance is instructive regarding what the EPA will require before it will enter into a de minimis settlement. Essentially, the landowner seeking a de minimis settlement must go through all the steps needed to establish an innocent landowner defense.¹³⁷ The difference is that while such steps might not be enough to satisfy the amorphous "all appropriate inquiry" requirement, they may be enough to convince the EPA to enter into a settlement agreement. "The reason, of course, is to encourage the landowner to settle rather than fight."¹³⁸

133. SARA § 122(g)(1)(B), 42 U.S.C. § 9622(g)(1)(B) (Supp. V 1987).

134. SARA § 122(g)(1)(A), 42 U.S.C. § 9622(g)(1)(A) (Supp. V 1987).

135. SARA § 122(g)(1)(B), 42 U.S.C. § 9622(g)(1)(B) (Supp. V 1987).

136. *Id.*

137. See GUIDANCE ON LANDOWNER LIABILITY, *supra* note 99, at 18; O'Brien, *supra* note 100, at 172-73.

138. O'Brien, *supra* note 100, at 173.

VI. CONCLUSION

The challenge for those who enforce the Superfund program, as well as courts which place a final interpretation upon its provisions, is to fashion a rule of CERCLA lender liability that is faithful to the statutory language as well as the intent of the statute. Congress, which unwittingly thrust upon the executive and judicial branches this uncertain and difficult task, may choose to conclude its unfinished business by clarifying the liability of lenders as the Superfund statute comes up for reauthorization in 1991. Meanwhile, lenders must devise a strategy for coping with the ambiguity and potentially ruinous liability lurking in their transactions if they are to remain healthy and competitive in the real estate finance business.