Lender Liability Under Superfund: New Rules? Old Rules? No Rules?

by Robert M. Harkins, Jr.

Introduction

Congress created the Comprehensive Environmental Response, Compensation and Liability Act, also known as CERCLA or Superfund,[1] to "facilitate the prompt clean-up of hazardous waste sites."[2] Naturally, a party who actually introduces a contaminant to a site may be held liable for cleanup costs, as well as the site's owner or operator.[3] But questions arise when prosecutors attempt to hold paper owners liable, such as lenders who hold title to property but have no other contact with it.

Potential liability is of crucial importance to lenders, borrowers, and potential plaintiffs. For lenders, CERCLA holds special dangers because the Act institutes a system of strict, joint, and several liability which provides that parties may be liable for the total cleanup costs of a site, even if they are not directly responsible for the discharge of hazardous waste.[4] If lenders are potentially liable, they are less likely to back certain loans, which adversely impacts the market for possible borrowers. On the other hand, if lenders are not liable, private plaintiffs and the EPA will have fewer avenues for collecting money to clean up hazardous waste sites. Additionally, fewer responsible parties may translate into fewer parties concerned with eliminating toxic waste hazards, a primary concern of Congress when it passed the Act.[5]

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When Congress passed CERCLA, it responded to the potential for unfair assignment of liability to parties completely removed from property management. While lenders might in some cases be considered owners or operators, the Act expressly excludes, "A person who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect a security interest."[6] This exception is known as the "secured creditor exemption."[7]

This article follows the debate over when secured creditors cross the line and become owners or operators and may thereby incur liability. Part I traces the saga of lender liability through the language of sections 107 and 101(20)(A), the confusion in judicial interpretation, and the EPA's response of creating new regulations to help eliminate the confusion. Part II reviews the February 1994 D.C. Circuit decision in Chemical Mfrs. Ass'n v. EPA[8] which effectively eliminated the EPA regulations. Part III views possible future efforts by the EPA and Congress to reassert the regulations. Part IV summarizes the position as it stands today for lenders, borrowers, and plaintiffs, and discusses environmental implications. The article concludes by suggesting that the only sure way for lenders to avoid liability is to practice extreme caution with regard to environmentally risky sites, and that by doing so they will best meet the goals of CERCLA as well as protect their assets.

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Part I. The Saga of Lender Liability under Superfund

A. Old Rules Are No Rules - The Ambiguity in CERCLA § 107

Under the language of section 107, parties are liable for being either "owners or operators" of the Superfund site.[9] Taken alone, this language could possibly include anyone with a claim of ownership, including lenders and other creditors with a claim on title who are not involved in the operation of the site. Congress took this into consideration and created an exemption in section 101(20)(A) for, "A person who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect a security interest."[10]

Unfortunately, the language of section 107 does not distinguish "owners and operators" from mere security interest holders. For example, what if it a lender needs to foreclose on a property? Does it remain a lender, or does it become a owner with potential liability? What amount of involvement in protecting a lender's security interest is allowed before the lender "participates" in management? Does the exemption allow any kind of management? If so, how much? These questions were left for judicial interpretation. Court cases revolving around lender liability have therefore centered on just what constitutes ownership beyond merely protecting a security interest and how much participation in management will remove a lender from the secured creditor exemption.

1. Ownership Cases

The first case to deal with section 107 was United States v. Mirabile.[11] In that case, the a bank foreclosed on contaminated property and transferred interest four months later. The bank was subsequently added as a defendant to a CERCLA action. The district court held that because foreclosure was necessary to protect the lender's security interest, the act did not rise to the level of "ownership."

Later district court cases, however, came to the opposite conclusion. In United States v. Maryland Bank & Trust Co.,[12] the court decided that the exemption was only viable during the life of the mortgage. The facts were similar to Mirabile, except that the bank held the property in question for four years rather than four months. However, the court did not delineate between time periods after foreclosure. Instead, it imposed liability on the bank, stating that the act of foreclosure created an ownership interest beyond the secured creditor exemption.

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In Guidice v. BFG Electroplating & Manuf. Co., Inc.,[13] the Central District Court of California, citing Maryland Bank & Trust, came to the same conclusion that foreclosure took the lender out of the secured creditor exemption. The court found that the lender forfeited the exemption due to its ownership status, even though it only held the property in question for eight months before selling it.

2. Operator Cases

The Mirabile case also dealt with the question of operator status. It determined that a lender does not lose the secured creditor exemption by involvement in some management of a facility. Instead, the lender is only barred from participating in the "day-to-day operational aspects of the contaminated site."[14]

However, much to lenders' chagrin, the Eleventh Circuit more broadly defined what constitutes management beyond the scope of the secured creditor exemption. In United States v. Fleet Corp.,[15] the court rejected Fleet's motion for summary judgment. The court recognized that Congress created the secured creditor exemption to allow creditors to maintain their "normal course of business."[16] However, the decision went on to create the "capacity to influence" test. Regardless of whether the lender actually exercised power over a facility, it could be held liable if its involvement with management of the facility was broad enough to infer it could affect decision-making with regard to hazardous waste.[17]

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In In re Bergsoe[18] the Ninth Circuit looked at a factually similar situation to Fleet. While the court cited Fleet, it also used the opportunity to "clarify" the Fleet test. A municipality in Bergsoe held a security interest in a recycling plant but did not partake in management of the plant. The court held that the lender must actually exercise some management authority in order to remove itself from the secured creditor exemption. Merely possessing management power was not enough; "there must be some actual management."

The Ninth Circuit did not develop what kind of management activity would be considered "some actual management." Taken with Fleet, it would seem that any management, even purely financial, could be enough to create liability as long as the lender also held the capacity to influence hazardous waste decisions.

B. The New Rules: The EPA Defines the Lender Liability Exemption

The disagreement among courts in determining lender liability under Superfund left the lending community in disarray.[19] The American Bankers Association asserted that lenders curtailed loans to some classes of borrowers to avoid liability.[20] In some cases, lenders even abandoned properties instead of foreclosing on them for fear that they would assume liability for hazardous waste cleanup under Superfund.[21]

The EPA decided to take action in order to calm the fears of the banking community. First, it backed an effort in Congress to amend CERCLA. However, the CERCLA amendments in 1990 failed.[22] Without legislative action, the EPA's next step was to promulgate a lender liability rule defining the secured creditor exemption.[23] The final regulations dealing with problems of ownership and operator status emerged April 29,1992.[24]

40 C.F.R. § 300.1100(d) gave lenders the ability to foreclose on property without automatically opening themselves to liability. As long as the lender did not participate in management before foreclosing, the lender had one year to put the property up for sale. During the interim between foreclosure and sale, the lender could "take measures to preserve, protect or prepare the secured asset."[25] Such measures seemed to include dealing with environmental matters. In fact, the lender could undertake cleanup activities without falling out of the exemption.[26] The lender could not, however, arrange for or accept disposal of hazardous waste on the site.[27]

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With regard to operator status, the regulations established a number of activities in which lenders could participate without fear of losing their exemption, including policing the location prior to foreclosure; taking financial measures to prevent, cure, or mitigate default by the borrower; and requiring the borrower to clean up the site and comply with environmental laws.[28] While the crux of allowable activities is financial dealings, pressure to maintain an environmentally sound site was acceptable. This was distinguished from "day-to-day decisionmaking" with respect to environmental compliance, which would make the lender a potentially liable operator.[29]

Thus, the EPA regulations gave greater definition to the "owners and operators" clause of section 107(a). Lenders faced a situation more predicable and favorable than they had under previous case law, since they the regulations broadened the range of safe activity in dealing with potential Superfund sites.

II. *Chemical Manufacturers' Association v. EPA*: The End of the New Rules

The debate over lender liability has two opposing sides: lenders on one, plaintiffs who want to reach lender assets on the other. While the EPA regulations made results more predictable for all parties, that predictability weighed against potential plaintiffs. In response, the state of Michigan and the Chemical Manufacturers' Association brought a lawsuit against the EPA, claiming that the EPA did not have the statutory authority to limit lender liability and thereby restrict private rights of action under Superfund.[30] The disposition of Chemical Mfrs. Ass'n v. EPA effectively decided the fate of the EPA regulations, because the District of Columbia District Court has exclusive jurisdiction to review any regulation promulgated under the Act.[31]

Siding with the plaintiffs, the court vacated the regulations.[32] The court admitted that the EPA has broadly delegated responsibilities from the President.[33] However, the court determined that with regard to any particular regulation, the EPA must demonstrate "explicit or implicit evidence of congressional intent to delegate interpretive authority."[34] The court found that while the EPA could interpret certain administrative responsibilities, it lacked the congressional grant of authority regarding liability issues, especially since "Congress provided for de novo judicial review of the agency's 'particularized decision[s] respecting liability.'"[35] Therefore, the EPA lacked the power to create its own substantive rules regarding CERCLA liability.

The court also rejected the argument that the EPA was merely making an interpretive rule rather than a legislative regulation.[36] Normally, agency construction of legislation, while not binding like legislative regulation, is entitled to judicial deference.[37] The court found that the EPA's "interpretation" was really a comprehensive regulatory scheme and that it's quasi-legislative efforts at implementation belied the notion of mere interpretation.[38] The court went further, stating that EPA lacked even interpretive power in the area of liability, because Congress had specifically assigned liability issues to judicial review.[39] Thus, Chemical Manufacturers held that the EPA had no power of its own to define lender liability under the Act.

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III. What Happens to the Rules Now?

There are three ways that the lender liability provisions in Superfund may be defined: by further legislative definition passed by Congress, by EPA rule making, or by judicial interpretation. As the court in Chemical Manufacturers noted, a previous attempt in Congress failed. The court's decision eliminated the EPA's attempt at rule making, and prior judicial decisions had been criticized as conflicting and confusing. So what next?

One possibility is another attempt to pass legislation through Congress. This is the route suggested by the court in Chemical Manufacturers.[40] Presently, both the House and the Senate are considering a Superfund reform bill.[41] Among other provisions, the bill would give the EPA the authority to define lender liability that the District of Columbia Circuit Court held it presently lacks. The bill is backed by the Clinton administration. However, the bill does not seem to have strong support in Congress, so its likelihood of passage is questionable.[42]

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Second, the EPA could attempt to create an interpretation of lender liability that the D.C. Circuit Court would find acceptable. In the Chemical Manufacturers' case, the EPA claimed that its regulation was substantive, or, in the alternative, interpretive. The court disliked the EPA's "attempt[] to straddle two horses."[43] It found that under the circumstances and by the language and complex system set up in 40 C.F.R. § 300.1100, the EPA was really making substantive legislation. Perhaps a more genuinely interpretive rule would be viewed more favorably by the already divided court.[44] However, an alternative ruling by the court suggests that even a clearly interpretive rule is not within the EPA's power.[45] Therefore, chances of a second, successful regulation seem poor.

Therefore, the situation with regard to lender liability is much the same as it was preceding the EPA rule promulgation. While presently confusing, future litigation may further clarify how foreclosure turns a lender into an owner and how much management is too much.

IV. Dealing with Uncertainty

Superfund plaintiffs clearly win out in the recent D.C. Circuit decision. With regard to ownership, the weight of lower court rulings indicates that foreclosure alone is enough to create liability. The standards for lender liability as an operator revert to those under Fleet, perhaps as modified by the Ninth Circuit in Bergsoe. Under those cases, any lender dealings with management regarding environmental matters would create potential liability.

There is one other possibility of future occurrences. One reason for the varying court decisions may be that courts were grappling with an entirely new area of statutory interpretation. The EPA regulations are officially void now, but they still provide interpretive opinion from the administrative agency of Superfund. While the regulations are due no deference, courts may draw upon the regulatory regimen to standardize their interpretations. However, because the regulations are due no deference, only time will tell what impact they still may have. Precedents in the Eleventh and Ninth Circuits suggest that in those jurisdictions lenders have much less leeway before incurring liability.

For lenders who unknowingly become owners or operators of toxic sites, CERCLA provides defenses in § 107(b). Owners are exempted from liability for contamination from acts of war, god, a third party, or any combination of the three.[46] In order to qualify for the third party defense, the burden of proof falls on the defendant to prove that the contamination was caused exclusively by a third party unrelated by contractual relationship with the defendant.[47] Transfer of title is considered a contractual relationship, but not if the defendant shows that it did not know and had no reason to know about the hazardous waste, or that the defendant inherited the property.[48] To prove "no reason to know," the defendant must show that it reasonably inquired into the previous ownership and uses of the property.[49]

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Because of its strict requirements, the third party defense, or "innocent purchaser defense," is a kind of last resort for lenders to avoid liability.[50] The best bet for lenders is to be as cautious as possible, which will increase lenders ability to invoke the innocent purchaser defense in the rare cases they are named defendants. Lenders can and should take a multitude of precautions to ensure an environmentally sound property interest. Lenders should conduct an environmental audit of each site, including visual inspection of the site and a review of all documentation that might reveal contamination.[51] Other measures may also be taken, including a requirement of contamination notice in the loan agreement.[52] Interestingly, this kind of detailed interest in a property and possible contamination on the property meets the goals of CERCLA to maintain a clean environment and minimize risk of contamination.

Conclusion

Superfund holds owners and operators of a contaminated site potentially liable. Exempted from liability are security interest holders who do not participate in management of the site. The language of the statute with regard to lender liability fails to provide bright line distinction between lenders and owners or operators, resulting in conflicting court interpretations. The EPA responded to pressure from lenders to more clearly define the exemption by promulgating a set of regulations under 40 C.F.R. § 300.1100. Recently, however, the D.C. Circuit Court vacated those rules, holding that the EPA lacks the power to limit liability. Passage of the Superfund Reform Act would change that, but it's passage is not likely in the short term. Lenders are left, therefore, to deal with court holdings that leave little room for mistakes. In this environment, the goals of CERCLA might be met after all, because in order to avoid liability, lenders will be driven to extreme caution and environmental safety-consciousness. A lender who fails to take extra care to avoid involvement in hazardous waste sites faces liability, giving the EPA and plaintiffs another party from which to seek contribution.

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NOTES

1. 42 U.S.C. §§ 9601 et seq. Although all provisions of Superfund are codified beginning at section 9601, commentators and courts often refer to the original section numbers as found in the bill, beginning with section 101. Section 107 (which this article focuses on), for example, is codified at 42 U.S.C. § 9607.

2. S. Rep. No. 848, 96th Cong., 2d Sess. 33 (1980). CERCLA has four major parts. The Act allows the gathering of information and designation of hazardous substances (§ 102), authorizes the cleanup of hazardous sites (§ 104), creates a trust fund to help pay for cleanup (§ 111), and establishes a system for assigning liability to parties connected to the sites (§§ 106-107).

3. Section 107(a) creates four categories of parties who may be held liable for cleanup costs, also known as potentially responsible parties (PRPs): (1) any owner or operator; (2) any person who was an owner or operator at the time of disposal; (3) any person who contracted to have a hazardous substance transported; and (4) any person who was involved in the transport of a hazardous substance. This article focus on the first category, consisting of owners and operators.

4. For a recent discussion of strict, joint, and several liability under Superfund, see Robert M. Harkins, Jr., Environmental Protection Agency v. Sequa and the Erosion of Joint and Several Liability Under Superfund, ENVIRONS, Dec. 1993, at 30.

5. 42 U.S.C. § 9607.

6. 42 U.S.C. § 9601(20)(A).

7. Sean Sweeny, Owner Beware: Lender Liability and CERCLA, ABA JOURNAL, Feb. 1993, at 68, 69.

8. No 92-1312, 1994 U.S. App. LEXIS 1715 (D.C. Cir. Feb. 4, 1994).

9. 42 U.S.C. § 9607.

10. 42 U.S.C. § 9601(20)(A).

11. No. 84-2280, slip op. at 3 (E.D. Pa. Sept. 6, 1985), 15 E.L.R. 20994 (1985).

12. 632 F.Supp. 573 (D. Md. 1986).

13. 732 F.Supp. 556 (C.D. Cal. 1989).

14. United States v. Mirabile, No. 84-2280, slip op. at 3 (E.D. Pa. Sept. 6, 1985), 15 E.L.R. 20994 (1985).

15. 901 F.2d 1550 (11th Cir. 1990), cert. denied, 498 U.S. 1046 (1991).

16. Id. at 1556.

17. Id. at 1558. "[A] secured creditor will be liable if its involvement with management is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose." Id.

18. 910 F.2d 668 (9th Cir. 1990).

19. Chemical Manuf. Assoc. v. Environmental Protection Agency, No 92-1312, 1994 U.S. App. LEXIS 1715, at *6 (D.C. Cir. Feb. 4, 1994).

20. Id.

21. Id.

22. See, e.g., H.R. 4494, 101st Cong., 2d Sess. (1990), 136 Cong. Rec. H1505 (daily ed. Apr. 4, 1990).

23. 56 Fed. Reg. 28,798 (1991).

24. 40 C.F.R. pt. 300, as amended, 57 Fed. Reg. 18,344 (Apr. 29, 1992).

25. 40 C.F.R. § 300.1100(d).

26. 40 C.F.R. § 300.1100(d)(3)(ii).

27. 40 C.F.R. § 300.1100(d)(3)(i).

28. 40 C.F.R. § 300.1100(c)(2).

29. 40 C.F.R. § 300.1100(c)(1)(ii)(A).

30. Chemical Mfrs. Ass'n v. Environmental Protection Agency, No 92-1312, 1994 U.S. App. LEXIS 1715, at *6 (D.C. Cir. Feb. 4, 1994).

31. 42 U.S.C. § 9613(a).

32. 1994 U.S. App. LEXIS 1715, at *28.

33. Id. at *10. See also Wagner Seed Co., Inc. v. Bush, 946 F.2d 918, 920 (D.C. Cir. 1991), cert. denied, 112 S. Ct. 1584 (1992).

34. 1994 U.S. App. LEXIS 1715, at *10 (citing Linemaster Switch Corp. v. EPA, 938 F.2d (D.C. Cir. 1991)).

35. Id. at *12. A congressional mandate of "de novo" review by a court means the court should give no deference to the agency determination, instead trying the case as if it were being heard for the first time.

36. Id. at *23.

37. The seminal case granting deference to agency interpretative rules is the U.S. Supreme Court decision Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).

38. 1994 U.S. App. LEXIS 1715, at *24.

39. Id. at *25.

40. Id. at *28.

41. H.R. 3800 & S. 1384, 105th Cong., 2d Sess. (1994). If passed, the law will be called the Superfund Reform Act.

42. Battle Weary Congress May Bag Reform Effort, HAZARDOUS WASTE NEWS, Feb. 8, 1994.

43. 1994 U.S. App. LEXIS 1715, at *23.

44. The decision was 2-1, with Judge Silberman dissenting.

45. Id. at 25. See also supra notes 31 & 35 and accompanying text.

46. 42 U.S.C. § 9607(b).

47. 42 U.S.C. § 9607(b)(3).

48. 42 U.S.C. § 9601(35)(A). The section also exempts government entities that obtain property by escheat.

49. 42 U.S.C. § 9601(35)(B).

50. Sweeny, supra note 7, at 71.

51. Id.

52. Id.