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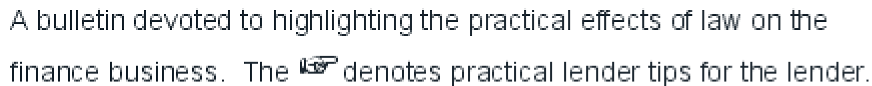
The Practical Lender



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Contributing Author: Adam S. Lewis

Contributing Editor: Joseph A. Strubbe

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ENVIRONMENTAL LENDER LIABILITY UPDATE: THE CURRENT LEGAL "ENVIRONMENT"

A major concern for lenders is the possibility of incurring direct liability under federal and state environmental laws for the clean-up of contaminated properties securing loans. The purpose of this bulletin is to guide lenders through the maze of federal and state laws defining the current status of environmental lender liability.

Federal Law

Background. The principal federal law giving rise to lender liability is the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA" or "Superfund").[1] CERCLA empowers the Environmental Protection Agency ("EPA") to clean up contaminated sites and to recover from "potentially responsible parties" ("PRPs") its cost of investigation and clean-up. CERCLA defines PRPs as: (1) current "owners" or "operators" of a facility; (2) "owners" or "operators" of a facility at the time disposal activities took place (past "owners" or "operators"); (3) persons who arranged for disposal of hazardous substances (often referred to as generators of hazardous substances); and (4) transporters of hazardous substances.[2] Typically, the EPA and third parties seeking indemnification or contribution under CERCLA have targeted financial institutions for liability as "owners" or "operators." Because of the courts' broad application of CERCLA, financial institutions holding interests in contaminated properties were often found liable under those definitions.

However, financial institutions and other secured creditors have benefited from the so-called "security interest

exemption" set forth in CERCLA. This exemption provides that a "person" will not be deemed an "owner" or "operator" of the property if, without participating in management of the property, it merely holds an "indicia of ownership" to protect its security interest.[3] The security interest exemption is not solely limited to mortgagee/mortgagor relationships. Courts have expanded the exemption to include lenders involved in lease financing transactions.

Nevertheless, CERCLA does not define the phrase "participation in management," nor does it set forth guidance as to how much involvement in a facility's management a secured lender may have before it loses the exemption. In April 1992, in response to the absence of legislative guidance, the EPA promulgated its Lender Liability Rule interpreting the exemption. The rule described the activities that secured lenders may undertake without "participating in management," and provided "safe harbors" for lenders with troubled loans secured by contaminated properties. This rule was struck down by the Court of Appeals for the D.C. Circuit in *Kelley v. EPA* in 1994.[4] The court held that the EPA lacked the statutory authority to promulgate the Lender Liability Rule.

Statutory Lender Liability Rule. In 1996, Congress enacted "The Economic Growth and Regulatory Paperwork Reduction Act of 1996" (the "Act") which amended CERCLA. The Act negated the decision in *Kelley v. EPA* by codifying the EPA's 1992 Lender Liability Rule.[5] Under the Act, a lender is not considered as having participated in management so long as it exercises any of the usual rights granted under security interests or a related foreclosure in connection with an extension of credit.[6] Prior to foreclosure, participating in management includes exercising "decision-making control" over environmental compliance or otherwise exercising control comparable to that of a manager over management, whether or not environmental compliance is actually included.[7] Following foreclosure, a lender is generally exempt, provided the lender seeks to sell, re-lease (in the case of lease finance transactions), or otherwise divest the facility or vessel at the "earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."[8] Under the foregoing exemption, the lender has considerable freedom to act with respect to the

foreclosed property. So long as the lender seeks to divest as described above, the lender may, among other actions, liquidate the property, undertake a response pursuant to Section 9607(d) of CERCLA (i.e., render care, assistance, or advice in accordance with the National Contingency Plan) or under the direction of a coordinator (appointed pursuant to the National Contingency Plan), or take any "other measure to preserve, protect or prepare" the property prior to sale or disposition.[9]

Fiduciaries also benefit from a liability safe harbor under the Act. Liability under CERCLA for release or threatened release of a hazardous substance, in connection with assets held in a fiduciary capacity, shall not exceed the assets so held, provided negligence of the fiduciary does not cause or contribute to the release. The Act also provides that a fiduciary will not be liable, in its individual capacity, for responding generally to clean-up responsibilities, including environmental compliance terms or conditions in fiduciary agreements, altering such terms or conditions, or administering vessels or facilities that were contaminated before the beginning of the fiduciary relationship as a fiduciary.[10]

Illinois State Law

Although the State of Illinois has not adopted a Lender Liability Rule, July 1996 amendments to the Illinois Environmental Protection Act (the "Illinois Act") represent a significant change to the Illinois liability scheme for "potentially responsible parties."[11] This change provides protection to financial institutions. Prior to the 1996 amendments of the Illinois Act, Section 22.2 (f) mimicked the CERCLA liability scheme, holding that certain parties (these parties include the same persons who are classified as PRPs under CERCLA) be jointly and severally liable for the costs of removal or remedial action incurred by the State of Illinois or any unit of local government as a result of a release or substantial threat of release of a hazardous substance or pesticide.[12] However, in 1996, the Illinois General Assembly repealed joint and several liability and replaced it with a fault-based, proportionate share liability scheme.[13] This fault-based liability scheme reduces a person's liability to damages that were proximately caused by such person's act or omission. The amendments to the Illinois Act also require the Illinois Pollution Control Board to adopt

administrative rules, which will outline the "criteria for the determination of apportioned responsibility based upon the degree to which a person directly caused or contributed to the release" of hazardous waste.[14]

The 1996 amendments to the Illinois Act also include provisions for the administrative approval of clean-ups, which protect lenders and other parties from liability. The voluntary Site Remediation Program ("SRP") contains procedures that allow an owner or operator to voluntarily remediate contaminated property with the Illinois Environmental Protection Agency's (the "IEPA") approval.[15] Upon the proper completion of the required procedures, the IEPA will issue a No Further Remediation Letter, which "signifies the release from further responsibilities under [the Illinois Act] in performing the approved remedial action and shall be considered prima facie evidence that the site does not constitute a threat to human health and the environment and does not require further remediation under [the Illinois Act], so long as the site is utilized in accordance with the terms of the No Further Remediation Letter."[16] The No Further Remediation Letter applies in favor of "[a]ny financial institution…that has acquired the ownership, operation, management, or control of a site through foreclosure or under the terms of a security interest held by the financial institution, under the terms of an extension of credit made by the financial institution, or any successor in interest hereto."[17]

The SRP is a viable, cost-effective measure that "owners" and "operators" of contaminated sites can take to avoid further liability. The SRP is limited, however, and typically will not be available for a property that is already the subject of a federal or state enforcement action. An "owner" or "operator" must therefore refer to the Illinois Act to determine whether the contaminated site is within the scope of the SRP.

Conclusion

The amendments under CERCLA and the Illinois Act have significantly reduced the exposure that lenders have to liabilities resulting from environmental investigations and remediations. However, lenders must not become complacent, since the protections from exposure to liability are not absolute. Moreover, notwithstanding any

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favorable environmental laws, lenders remain "exposed" to the risks posed by contaminated properties. A borrower may default on the loan, and the property securing repayment of that loan may have no value as a result of contamination. Therefore, despite the advances made to limit lender liability for environmental issues, lenders must still diligently review environmental issues when taking a security interest in real estate.

[1]42 U.S.C. §9601 *et seq.*.

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[2]42 U.S.C. §9607(a).

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[3]42 U.S.C. §9601(20)(A).

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[4]*Kelley v. EPA*, 15 F.3d 1100 (D.C. Cir. 1994), *rehg denied,* 25 F.3d 1088 (D.C. Cir. 1994), *as amended, cert denied American Bankers Ass'n v. Kelley*, 115 S.Ct. 900 (Jan. 17, 1995).

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[5]42 U.S.C. §9601(20)(E-G).

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[6]42 U.S.C. §9601(20)(F).

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[7]*Id.*

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[8]42 U.S.C. §9601(E)(ii).

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[9]*Id.*

Price, Kaufman & Kammholz, P.C.

Chicago
222 North LaSalle Street
Chicago, Illinois 60601
312/609-7500
Facsimile: 312/609-5005

New York
805 Third Avenue
New York, New York 10022
212/407-7700
Facsimile: 212/407-7799

New Jersey
354 Eisenhower Parkway
Plaza II
Livingston, New Jersey 07039
973/597-1100
Facsimile: 973/597-9607

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[10] 42 U.S.C. §9607(n).

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[11] 415 ILCS 5/58 *et seq.*.

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[12] 415 ILCS 5/22.2(f).

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[13] 415 ILCS 5/58.9.

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[14] *Id.*

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[15] 415 ILCS 5/58 *et seq.*

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[16] 415 ILCS 5/58.10.

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[17] 415 ILCS 5/58.10(10).

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