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# From the Bankruptcy Courts

*Benjamin Weintraub\* and Alan N. Resnick\*\**

## **SECURED CREDITOR'S LIABILITY FOR HAZARDOUS WASTE CLEAN- UP COSTS: THE WARNING OF FLEET FACTORS**

When banks and finance companies find a borrower's business operations inadequate to sustain repayment of a loan, they turn to collateral for comfort. When the collateral is real estate plagued by hazardous waste contamination, the land may have little or no salable value. This risk of being left with valueless collateral is not new to secured lenders, but a much more troubling problem now facing financiers is the additional risk that secured creditors may be liable under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA)<sup>1</sup> for clean-up costs associated with hazardous wastes created by the debtor.

### **The Facts of the Case**

A recent case decided by the Court of Appeals for the Ninth Cir-

cuit, *United States v. Fleet Factors Corp.*,<sup>2</sup> comes to grips with this problem and presents several caveats to lenders. In 1976, Swainsboro Print Works (SPW), a cloth-printing facility, entered into a factoring agreement with Fleet Factors Corp. under which Fleet Factors agreed to advance funds against an assignment of SPW's accounts receivable. As collateral for these advances, Fleet Factors obtained a security interest in SPW's textile facility and of all of the equipment, inventory and fixtures.

SPW filed a petition under chapter 11 in August 1979. The factoring agreement continued with court approval, but early in 1981, Fleet Factors ceased advancing funds to SPW because the debt to Fleet Factors exceeded its own estimate of the value of SPW's accounts receivable. Shortly thereafter, on February 17, 1981, SPW ceased operations and began liquidating its inventory. Fleet Factors, however, continued to collect the assigned accounts receivable. In December 1981, the case was converted to a chapter 7 liquidation, and a trustee assumed control of the facility.

In May 1982, Fleet Factors foreclosed on its security interest in

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<sup>1</sup> 42 U.S.C. §§ 9601 et seq. (1980).

<sup>2</sup> 901 F.2d 1550 (11th Cir. 1990).

some of SPW's inventory and equipment, and contracted with a liquidator to sell it at an auction. In June, the collateral was sold "as is" and "in place" so that removal of the items was the responsibility of the purchasers. In August, Fleet Factors allegedly contracted with Nix Riggers to remove the unsold equipment in consideration for leaving the premises "broom clean."<sup>3</sup> Nix testified in a deposition that he was given a free hand by Fleet or the liquidator to do whatever was necessary at the facility to remove the machinery and equipment. Nix left the facility at the end of 1983.

### EPA Inspection

In January 1984, the Environmental Protection Agency (EPA)<sup>4</sup> inspected the facility and found 700 55-gallon drums containing toxic chemicals and 44 truckloads of material containing asbestos. In responding to the environmental threat at SPW, the EPA incurred costs of \$400,000. The facility was conveyed to Emanuel County, Georgia, at a foreclosure sale in July 1987 resulting from SPW's failure to pay state and county taxes.

The government sued the two principal officers and stockholders of SPW as well as Fleet Factors to recover the costs of cleaning up the hazardous waste. The district court granted the government's motion

for summary judgment with respect to the liability of the officers and stockholders for the cost of removing the hazardous waste in the drums but denied the motion with respect to the asbestos removal costs. Most importantly, the Fleet Factors motion for summary judgment was also denied, and Fleet Factors appealed.

### Court of Appeals

The court of appeals observed that CERCLA was enacted by Congress in response to the environmental and public health hazards caused by the improper disposal of hazardous waste, and that the "essential policy" underlying CERCLA was to place the ultimate responsibility for cleaning up hazardous waste on "those responsible for problems caused by the disposal of chemical poison."<sup>5</sup> To carry out such responsibility, CERCLA authorizes the federal government to clean up hazardous waste sites and recover the costs from certain categories of responsible parties:

The parties liable for costs incurred by the government in responding to an environmental hazard are: (1) the present owners and operators of a facility where hazardous wastes were released or are in danger of being released; (2) the owners or operators of a facility at the time the hazardous wastes were disposed; (3) the person or entity that arranged for the treatment or disposal of substances at the facility.

<sup>3</sup> 901 F.2d at 1553.

<sup>4</sup> See 42 U.S.C. § 9601(2): "The term 'administrator' means the Administrator of the United States Environmental Protection Agency."

<sup>5</sup> 901 F.2d at 1553.

ty; and (4) the person or entity that transported the substances to the facility.<sup>6</sup>

The government's position was that Fleet Factors was liable for the response costs associated with the waste at the SPW facility as either a present owner and operator of the facility<sup>7</sup> or the owner or operator of the facility at the time that the wastes were disposed.<sup>8</sup> The district court rejected as a matter of law the government's claim that Fleet Factors was a present owner of the facility but found a genuine issue of fact as to whether Fleet Factors was an owner or operator of the SPW facility at the time that the wastes were disposed and, therefore, it denied Fleet Factors's motion for summary judgment.

### "Present Owner" Construed

Addressing the applicable sections of CERCLA, the court first discussed 42 U.S.C. § 9607(a)(1), which holds the owner or operator<sup>9</sup> of a facility containing hazardous waste liable for expenses incurred in responding to the environmental and health hazards presented by the

waste in that facility. The court construed the present owner and operator of a facility as the individual or entity owning or operating the facility at the time that the plaintiff initiated the lawsuit by filing the complaint.

Reviewing the facts from July 9, 1987, the date that the litigation commenced, the court found that the owner of the SPW facility was Emanuel County, Georgia. Under CERCLA, however, a state or local government that has involuntarily acquired title to a facility generally is not held liable as the owner or operator of the facility.

Instead, the statute provides:

[i]n the case of any facility, title or control of which was conveyed due to bankruptcy, foreclosure, tax delinquency, abandonment, or similar means to a unit of a State or local government [its owner or operator is] any person who owned, operated or otherwise controlled activities at such facility *immediately beforehand*.<sup>10</sup>

The parties disagreed as to the interpretation of the phrase "immediately beforehand." The district court had held that Fleet Factors could not be liable under Section 9607(a)(1) because it had never foreclosed on the facility, and its agents had not been on the premises since December 1983. The court of appeals agreed with Fleet Factors that "the plain meaning of the phrase 'immediately beforehand'

<sup>6</sup> 901 F.2d at 1553-1554. "The term facility means (A) any building, structure...." 42 U.S.C. § 9601(9).

<sup>7</sup> See 42 U.S.C. § 9607(a)(1).

<sup>8</sup> See 42 U.S.C. § 9607(a)(2).

<sup>9</sup> 901 F.2d at 1554. See *id.* at 1554 n.3: "Although the 'owner and operator' language of § 9607(a)(1) is in the conjunctive, we construe this language in the disjunctive in accordance with the legislative history of CERCLA and the persuasive interpretations of other federal courts" (citations omitted).

<sup>10</sup> 42 U.S.C. § 9601(20)(A)(iii) (emphasis added).

means without intervening ownership, operation, and control."<sup>11</sup>

### No Ownership, Operation, or Control

Accordingly, the court of appeals held that Fleet Factors could not be held liable under Section 9607(a)(1) because it neither owned, operated, nor controlled SPW immediately prior to Emanuel County's acquisition of the facility. Thus, from December 1981, when SPW became a debtor under chapter 7 of the Bankruptcy Code, until the July 1987 foreclosure sale, the bankruptcy estate and trustee were the owners of the facility; Fleet Factors' involvement with SPW terminated more than three years before the county assumed ownership of the facility. The court also observed that it was of no moment that the bankruptcy trustee might not have effectively exercised control of the facility. "To reach back to Fleet's involvement with the facility prior to December 1983 in order to impose liability would torture the plain statutory meaning of 'immediately beforehand.'" <sup>12</sup>

Liability is also imposed under Section 9607(a)(2) of CERCLA on "any person who at the time of disposal of any hazardous substance owned or operated any . . . facility at which such hazardous substances were disposed of. . . ." <sup>13</sup> Excluded from the definition of "owner or

operator" is any "person, who, without participating in the management of a . . . facility, holds indicia of ownership primarily to protect his security interest in the . . . facility." <sup>14</sup> The court of appeals held that Fleet Factors had the burden of establishing its entitlement to this exemption:

There is no dispute that Fleet held an 'indicia of ownership' in the facility through its deed of trust to SPW, and that this interest was held primarily to protect its security interest in the facility. *The critical issue is whether Fleet participated in management sufficiently to incur liability under the statute.* <sup>15</sup>

### Secured Creditor Exception

Observing that the construction of the "secured creditor exemption" was an issue of first impression in the federal appellate courts, the court of appeals rejected the government's urging of a literal interpretation of the exemption that would exclude from its protection any secured creditor that participates "in any manner" in the management of a facility. Such a narrow

<sup>14</sup> *Id.*

<sup>15</sup> 901 F.2d at 1556 (emphasis added). In a footnote, the court recognized the distinction between Fleet Factors' possible liability under 42 U.S.C. § 9607(a)(2) as operator and, alternatively, Fleet Factors' possible liability by having an indicia of ownership and managing the facility to the extent necessary to remove it from the secured creditor liability exception. "In order to avoid repetition, and because this case fits more snugly under a secured creditor analysis, we will forego an analysis of Fleet's liability as an operator." *Id.* at 1554 n.6.

<sup>11</sup> 901 F.2d at 1555.

<sup>12</sup> *Id.*

<sup>13</sup> See also 42 U.S.C. § 9601(20)(A).

interpretation would eradicate the exemption Congress intended to afford secured creditors, the court said:

Secured lenders frequently have some involvement in the financial affairs of their debtors in order to insure that their interests are being adequately protected. To adopt the government's interpretation of the secured creditor exemption could expose all such lenders to CERCLA liability for engaging in their normal course of business.<sup>16</sup>

Fleet Factors urged the court to adopt the distinction enunciated by several district courts between permissible participation in the financial management of the facility and impermissible participation in the day-to-day or operational management. Such a distinction was made in *United States v. Mirabile*,<sup>17</sup> a decision relied on by the district court in *Fleet Factors*. The district court interpreted the statutory language to permit 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."<sup>18</sup>

### District Court "Too Permissive"

The district court applied this interpretation to conclude that until Fleet Factors's liquidator entered the facility in June 1982, Fleet Factors's activity did not rise to the level of participation in management sufficient to impose CERCLA liability. The district court, however, determined that after Fleet Factors's liquidator entered the facility, the facts alleged by the government relating to Fleet Factors's involvement were sufficient to preclude the granting of summary judgment in favor of Fleet Factors. Although the court of appeals agreed with the district court's decision on the motion for summary judgment, it found its construction of the statutory secured creditor exemption too permissive toward secured creditors who are involved with toxic waste facilities:

The district court's broad interpretation of the exemption would essentially require a secured creditor to be involved in the operations of a facility in order to incur liability. This construction ignores the plain language of the exemption and essentially renders it meaningless. Individuals and entities involved in the operations of a facility are already liable as operators under the express language of section 9607(a)(2). Had Congress intended to absolve secured creditors from ownership liability, it would have done so. Instead, the statutory language chosen by Congress explicitly holds secured creditors liable if

<sup>16</sup> 901 F.2d at 1556.

<sup>17</sup> No. 84-2280, slip op. at 3 (E.D. Pa. Sept. 4, 1985).

<sup>18</sup> *United States v. Fleet Factors Corp.*, 724 F. Supp. 955, 960 (S.D. Ga. 1988); accord *Guidice v. BFG Electroplating & Mfg. Co.*, 732 F. Supp. 556, 561-562 (W.D. Pa. 1989); *United States v. Nicolet*, 712 F. Supp. 1193, 1205 (E.D. Pa. 1989).

*they participate in the management of a facility.*<sup>19</sup>

Analyzing the phrase "participating in the management" and the term "operator," the court of appeals observed that, although similar they were not congruent:

Under the standard we adopt today, a secured creditor may incur section 9607(a)(2) liability, without being an operator, by participating in the financial management of a facility to the degree indicating a capacity to influence the corporation's treatment of hazardous wastes. It is not necessary for the secured creditor actually to involve itself in the day-to-day operations of the facility in order to be liable—although such conduct will certainly lead to the loss of the protection of the statutory exemption. Nor is it necessary for the secured creditor to participate in management decisions relating to hazardous waste.<sup>20</sup>

The court of appeals construction of the secured creditor's exemption was, as the court indicated, less permissive than that of the district court's, yet broader than that urged by the government. The court stated that nothing in its decision should preclude a secured creditor from monitoring any aspect of a debtor's business, and moreover, a secured creditor could become involved in "occasional and discrete financial decisions relating to the protection of its security interest without incurring liability."<sup>21</sup>

<sup>19</sup> 901 F.2d at 1557 (emphasis added).

<sup>20</sup> 901 F.2d at 1558.

<sup>21</sup> *Id.*

## No Disincentive for Lenders

The court of appeals dismissed as "unfounded" any concern that the effect of its interpretation of the exemption provision for secured creditors might create disincentives for lenders to extend financial assistance to businesses with potential hazardous waste problems and might encourage secured creditors "to distance themselves from the management actions, particularly those related to hazardous wastes."<sup>22</sup> Critics might predict that the improper treatment of hazardous wastes could be perpetuated, rather than resolved, as a result of the decision.

Quite to the contrary, the court of appeals was confident that its interpretation of the statute should encourage potential creditors to investigate thoroughly the waste treatment systems and policies of potential debtors. "If the treatment systems seem inadequate, the risk of CERCLA liability will be weighed into the terms of the loan agreement."<sup>23</sup> The court viewed its decision as one that will further the aims of CERCLA by enlisting the aid of secured lenders, saying:

[D]ebtors, aware that inadequate hazardous waste treatment will have a significant adverse impact on their loan terms, will have powerful incen-

<sup>22</sup> *Id.* The court cited Guidice, 732 F. Supp. at 556, 562; Note, "Interpreting the Meaning of Lender Management Under Section 101(20)(A) of CERCLA," 98 Yale L.J. 925, 928, 944 (1989).

<sup>23</sup> 901 F.2d at 1558.

tives to improve their handling of hazardous wastes.

Similarly, creditors' awareness that they are potentially liable under CERCLA will encourage them to monitor the hazardous waste treatment systems and policies of their debtors and insist upon compliance with acceptable treatment standards as a prerequisite to continued and future financial support. . . . Once a secured creditor's involvement with a facility becomes sufficiently broad that it can anticipate losing its exemption from CERCLA liability, it will have a strong incentive to address hazardous waste problems at the facility rather than studiously avoiding the investigation and amelioration of the hazard.<sup>24</sup>

### Adequacy of Complaint

In applying its statutory interpretation to the case before it, the court of appeals agreed with the district court that the government alleged sufficient facts to hold Fleet Factors liable. Although Fleet Factors's conduct before SPW ceased printing operations in February 1981 fell within the scope of the secured creditor's exemption, Fleet Factors alleged involvement with SPW increased substantially thereafter when SPW ceased printing operations and began winding down its affairs. This involvement included requiring SPW to obtain Fleet Factors's approval before shipping goods to customers, establishing the price for excess inventory, dictating when and to whom the finished

goods should be shipped, determining when employees should be laid off, supervising the activity of the office administrator at the site, receiving and processing SPW's employment and tax forms, controlling access to the facility, and contracting with a liquidator to dispose of SPW's fixtures and equipment. Such involvement in financial management was "pervasive, if not complete,"<sup>25</sup> and, if proved, would be sufficient to place Fleet Factors outside the protection of CERCLA's secured creditor exemption. Additionally, the government alleged that Fleet Factors was also involved in the operational management of the facility: "Either of these allegations is sufficient as a matter of law to impose CERCLA liability on a secured creditor."<sup>26</sup> As to Fleet Factors's involvement at the facility from the time that it contracted with the liquidator in May 1982 until Nix left the facility in December 1983, the court of appeals agreed with the district court that Fleet Factors's alleged conduct brought it outside the secured creditor exemption. "Indeed, Fleet's involvement would pass the threshold for operator liability under [CERCLA]."<sup>27</sup>

### Secured Creditor Exemption Rejected

Fleet Factors contended that its activity at the facility from the time of the auction was within the se-

<sup>24</sup> 901 F.2d at 1558-1559.

<sup>25</sup> 901 F.2d at 1559.

<sup>26</sup> *Id.*

<sup>27</sup> 901 F.2d at 1560.



cured creditor exemption because it was merely protecting its security interest in the facility and foreclosing its security interest in its equipment, inventory, and fixtures. Rejecting this argument as immaterial, the court reasoned that "[w]hat is relevant is the nature and extent of the creditor's involvement with the facility, not its motive. To hold otherwise would enable secured creditors to take indifferent and irresponsible actions toward their debtors' hazardous wastes with impunity by incanting that they were protecting their security interests. Congress did not intend CERCLA to sanction such abdication of responsibility."<sup>28</sup>

The court of appeals agreed with the district court holding that Fleet Factors was not within the class of persons liable as a current owner or operator under Section 9607(a)(1). Although it found that the district court erred in construing the secured creditor exemption to protect Fleet Factors from CERCLA liability for its conduct prior to June 22, 1982, the court of appeals agreed with its ruling that Fleet Factors would be liable under Section 9607(a)(2) for its subsequent activities if the government could establish its allegations. Since there were disputed issues of material fact to be decided the case was remanded to the district court for further proceedings consistent with the opinion of the court of appeals.

### Conclusion

It is easy to see why financial institutions shudder at the court's conclusion that Fleet Factors may be liable under CERCLA for "participating in the management" of the facility. Fleet Factors was doing nothing more than protecting its security interest in its accounts receivable, inventory, and fixtures at a time when SPW had ceased operating. Nothing in Fleet Factors' conduct was inconsistent with a sale that would be conducted if the collateral were sold at a foreclosure sale. Indeed, the provisions of the Uniform Commercial Code<sup>29</sup> provide in part: "Unless otherwise agreed a secured party has on default the right to take possession of the collateral. In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace or may proceed by action." Preparing the collateral for sale after the debtor has ceased operations should not, for CERCLA purposes, constitute management or operation of a business even if the lender controls the shipping of goods and supervises the activities of the office administration at the site to maximize return on its collateral.

The effect of the *Fleet Factors* decision seems to have aroused the concern of financial institutions and has prompted a bill that has been presented in the House of Representatives to amend CERCLA to limit

<sup>28</sup> *Id.*

<sup>29</sup> U.C.C. § 9-503.

the liability of lending institutions and acquiring facilities through foreclosure or similar means and corporate fiduciaries administering estates or trusts. The bill would protect the following from CERCLA liability:

[A]ny designated lending institution which acquires ownership or control of the facility pursuant to the terms of a security interest held by a person in that facility.<sup>30</sup>

The Court of Appeals for the Eleventh Circuit has indicated a far-

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<sup>30</sup> H.R. 4494, 101st Cong., 2d Sess. (1990). [To Amend the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 to limit the liability under the Act of lending institutions acquiring facilities through foreclosure or similar means and corporate fiduciaries administering estates or trusts introduced April 4, 1990 and referred to House Energy and Commerce Committee. Bill died in August 1990.]

reaching definition of management that may not be followed by other courts and that may be statutorily overruled by the enactment of H.R. 4494.<sup>31</sup> For now, however, the court has clearly put the burden on financial institutions to investigate the waste treatment systems and policies of potential debtors. "If the treatment systems seem inadequate the risk of CERCLA liability will be weighed into the terms of the loan agreement."<sup>32</sup>

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<sup>31</sup> Cf. *In re Bergsoe Metal Corp.*, 910 F.2d 668, 673 n.3, (9th Cir. 1990), where the Ninth Circuit, referring to the holding in *Fleet Factors* as it affected the *Bergsoe* case, held: "As did the Eleventh Circuit in *Fleet Factors*, we hold that a creditor must, as a threshold matter, exercise actual management authority before it can be held liable for action or inaction which results in the discharge of hazardous wastes. Merely having the power to get involved in management, but failing to exercise it, is not enough."

<sup>32</sup> See note 23 *supra* and accompanying text.