Viable Protection Mechanisms for Lenders Against Hazardous Waste Liability

Laura E. Peck
VIABLE PROTECTION MECHANISMS FOR LENDERS AGAINST HAZARDOUS WASTE LIABILITY

I. INTRODUCTION

In the wake of recent legislative changes in environmental law regarding hazardous waste contamination, new liabilities and business risks have developed for lenders who secure loans with real property. Two situations presently exist in which lenders must be particularly concerned with the potential liability for cleanup costs at their borrowers’ hazardous waste sites. First, the lender may be held liable as an "owner or operator" of a facility if the lender becomes too closely involved in the management of the company, especially if the lender may be characterized as going beyond the control necessary to protect its financial interests. Second, the lender may also be held liable as an "owner or operator" if the lender forecloses on the property and does not re-sell it as soon as possible. Moreover, the scope of the affirmative defense available to the "innocent landowner" has been narrowed since the original legislation, thereby creating an environment where courts may begin to hold lenders liable when the activity of the lender is more closely related to the financial interest in the borrower.

A third concern for lenders is when a borrower files for bankruptcy. The Supreme Court has ruled that a property may not be abandoned in bankruptcy even if it is worth less than the cost of the cleanup. In addition, the cost of cleanup may be considered an ad-

2. See 42 U.S.C. § 9601(20)(A) (1982 & Supp. IV 1986); see also infra note 56 (discussing the definition of "owner" under CERCLA).
3. See infra notes 59-64 and accompanying text.
4. See infra notes 65-72 and accompanying text.
ministrative expense of the estate, thereby giving cleanup expenses incurred by the government priority over other creditors. 7

Nevertheless, it is unrealistic to anticipate that lenders will suspend financing those commercial transactions which may incur environmental hazards despite the threat of potential lender liability for cleanup. 8 Instead, lenders must develop measures to minimize their risks and become more aware of environmental concerns in order to identify and alleviate potential liability. 9

This Note examines the potential liability to lenders for hazardous waste disposal by their borrowers as well as the methods lenders may utilize to protect their investments by minimizing their risk of liability. These methods include: (1) obtaining environmental audits and reports, 10 (2) procuring pollution liability insurance, 11 (3) including indemnification clauses and warranties in security instruments, 12 and (4) requiring affirmative title insurance against hazardous waste. 13

II. SCOPE OF LIABILITY

A. Statutory Overview

In 1980, Congress enacted the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) 14 in response to the growing problem of environmental harm caused by improper

In *Midlantic Nat'l Bank*, the Supreme Court held that property could not be abandoned in a bankruptcy proceeding when a lien existed for the cleanup of hazardous waste on the premises. *Id.* at 505. The Court emphasized its holding applied even if the cost of cleanup exceeds the value of the property *Id.* at 497; see also *id.* § 506 (1982 & Supp. IV 1986) (ascertaining secured status under the Bankruptcy Code); *id.* § 507(a) (1982 & Supp. IV 1986) (determining priority in a bankruptcy proceeding). See generally sources cited *infra* note 85 (discussing the impact of hazardous waste litigation upon bankruptcy proceedings).

7. See *infra* notes 82-84 and accompanying text.

8. See *Banks Increasingly at Risk from Liability for Pollution Problems, Banking Official Says*, 17 Env'tl. Rep. (BNA) 1624 (Jan. 23, 1987) (noting that avoiding potential hazardous waste sites "would mean in large measure you would have to stay out of everything involving real estate"); *infra* notes 86-87 and accompanying text (discussing the impact of lenders refusing to loan to businesses with high risk of CERCLA liability).

9. See *infra* notes 86-90 and accompanying text (discussing the need to develop measures to minimize risk).

10. See *infra* notes 91-149 and accompanying text.

11. See *infra* notes 150-89 and accompanying text.

12. See *infra* notes 190-96 and accompanying text.

13. See *infra* notes 197-204 and accompanying text.

HAZARDOUS WASTE LIABILITY

disposal of hazardous waste.¹⁶ CERCLA was designed to supplement existing regulations dealing with hazardous waste, and to provide a means of enforcing and supervising the cleanup of hazardous waste contamination.¹⁶

CERCLA established regulations¹⁷ and funds¹⁸ for the cleanup


The Environmental Protection Agency (EPA) determines what substances are considered hazardous. Resource Conservation and Recovery Act (RCRA), 42 U.S.C. §§ 6901-6991 (1982 & Supp. IV 1986). RCRA empowers the EPA with the authority to regulate potentially hazardous substances and provides guidelines for the EPA to follow. Id. § 6911 (1982); see also infra notes 45-48 and accompanying text (discussing RCRA and its relationship to CERCLA).

¹⁶. See Burcat, supra note 15, at 511. CERCLA was enacted, in part, as a mechanism for immediate response by the government concerning hazardous waste sites. Id. The new legislation supplemented existing federal laws and regulations regarding hazardous materials established under RCRA. See 42 U.S.C. §§ 6901-6987 (1982 & Supp. IV. 1986).

¹⁷. See, e.g., 42 U.S.C. § 9621 (Supp. IV. 1986) (regulating cleanup standards and procedures); id. § 9607(a)(4)(A) (1982) (establishing cleanup liability for “all costs of removal or remedial action incurred by the [Federal] [G]overnment or a state . . . not inconsistent with the national contingency plan.”).

¹⁸. See Hall & Sullivan, Comprehensive Environmental Response, Compensation and Liability Act of 1980 (Superfund), in GOVERNMENT INSTITUTES, ENVIRONMENTAL LAW HANDBOOK 415, 416 (7th ed. 1983). A fund was established by CERCLA to pay for the immediate cleanup of the premises. Id. CERCLA is also known as “Superfund” legislation. Some states have also initiated legislation which allows the state to cleanup the property and then recover the costs from parties determined to be liable. See, e.g., New Jersey Environmental Cleanup Responsibility Act (ECRA), 1983 N.J. Laws ch. 330. A “superlien” is established to ensure payment of the cleanup by the liable party to the state and in some states, such as New Jersey, this lien is given priority over secured creditors. See id.

“The key purpose of [the] Superfund is to establish a mechanism of response for the immediate cleanup of hazardous waste contamination from an accidental spill or from chronic environmental damage such as is associated with an abandoned hazardous waste disposal site.” Hall & Sullivan, supra, at 416. The EPA is delegated responsibility from the President to cleanup hazardous waste contamination and is therefore able to use such funds to cleanup the waste site, and is also authorized to initiate lawsuits in order to have liable parties ultimately bear the cost of the cleanup. Exec. Order No. 12,316, 46 Fed. Reg. 42,237 (to be codified at 40 C.F.R. §300).

Financing of the fund comes from several sources:

The Hazardous Substance Response Fund . . . receives 87.5% of its revenue from petroleum and chemical feedstock taxes, with the remaining 12.5% coming from

Published by Scholarly Commons at Hofstra Law, 1989
of hazardous waste and attempted to develop expedient emergency abatement procedures in order to respond to the presence of hazardous waste in or at affected sites, even when the site has been abandoned. The purpose of this legislation was to facilitate the cleanup of hazardous waste disposal sites regardless of the legitimacy or illegality of the dumping. Since the cleanup costs of hazardous waste sites are astounding, the financial burden for the cleanup costs is imposed on parties responsible for creating the harmful condition.

Treasury appropriations. The taxes, imposed as of 1 April 1981 will remain in effect until 30 September 1985 or until $1.38 billion has accumulated in the Response Fund. This fund is available to respond to releases from any active, and most inactive, sites.

Hall & Sullivan, supra, at 416. A second fund, the Post-Closure Fund, provides money for the cleanup of sites which have been closed. Id. The revenue for the Post-Closure Fund comes from taxes levied on all hazardous waste and is collected at waste disposal facilities. Id. The tax remains in effect until $200 million has accumulated in the fund. Id.

19. Artesian Water Co. v. New Castle County, 659 F. Supp. 1269, 1276 (D. Del. 1987), aff'd, 851 F.2d 643 (3d Cir.1988) (providing a legislative overview of CERCLA). Chief Judge Schwartz explained that "[m]any of these sites had been abandoned by any party who could be held accountable for the cleanup. Wherever possible, however, CERCLA places the ultimate financial burden of toxic waste cleanup on those responsible for creating the harmful conditions." Id.; cf. United States v. Northeastern Pharmaceutical & Chem. Co., 579 F.Supp. 823 (W.D. Mo. 1984) (holding that although under CERCLA parties are liable for response costs of contaminated property which has been abandoned, the legislation is not retroactive with regard to non-negligent off-site transporters and generators), aff'd in part, rev'd in part, 810 F.2d 726, 734-37 (8th Cir.) cert. denied, 484 U.S. 848 (1987).

20. Hall & Sullivan, supra note 18, at 416; see also supra note 15 (discussing the legislative history of CERCLA).


22. CERCLA § 107(a) provides the following:

Notwithstanding any other provision or rule of law, and subject only to the defenses set forth in subsection (b) of the section . . . [accountable parties] shall be liable for—

(A) all costs of removal or remedial action incurred by the United States Government or a State not inconsistent with the national contingency plan; (B) any other necessary costs of response incurred by any other person consistent with the national contingency plan; and (C) damages for injury to, destruction of, or loss of natural resources, including the reasonable costs of assessing such injury, destruction, or loss resulting from such release.

42 U.S.C. § 9607(a) (1982); see also Artesian Water Co., 659 F. Supp. at 1277 (noting that "CERCLA provides that the federal government, state governments and private parties may sue those responsible for the generation, transportation, or disposal of hazardous substances.").

Courts have broadly construed § 107(a) and have imposed strict liability on potential defendants. For example, the Second Circuit held that a current owner of property who had knowledge of its condition may be responsible for response costs without regard to causation under § 107(a)(1), even though that party had not owned the site at the time of the dumping.
Liability under CERCLA is imposed on four classes of defendants: (1) present "owners or operators" of the hazardous waste site; (2) "owners or operators" of the site at the time of the waste disposal; (3) hazardous waste generators who arrange for disposal at the contaminated site; and (4) transporters of the hazardous material for disposal at the site. Strict liability has uniformly been construed when establishing a responsible party under section 107(a) of CERCLA. Liability, however, is subject to defenses under section 107(b) for release of hazardous material caused solely by an act of God, an act of war or an act or omission of a third party unrelated to the responsible party. New York v. Shore Realty Corp., 759 F.2d 1032, 1044-45 (2d Cir. 1985); accord United States v. Cauffman, 15 Envtl. L. Rep. (Envtl. L. Inst.) 20,161, 20,162 (C.D. Cal. Oct. 23, 1984) (holding that causation was not required to establish liability of property owner or operator). See generally Levitas & Hughes, Hazardous Waste Issues in Real Estate Transactions, 38 MERCER L. REV. 581, 592 (1987) (discussing the standards of liability under CERCLA).


24. CERCLA § 107(a), 42 U.S.C. § 9607(a) (1982). CERCLA § 107(a) defines the classes of liable parties as:

(1) the owner and operator of a vessel . . . or a facility,
(2) 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,
(3) any person who by contract, agreement, or otherwise arranged for disposal or treatment, . . . of hazardous substances owned or possessed by such person, by any other party or entity, at any facility owned or operated by another party or entity and containing hazardous substances, and
(4) any person who accepts or accepted any hazardous substances for transport to disposal or treatment facilities or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance.

Id. For further explanation and definition of "owner and operator," see infra notes 52-54 and accompanying text.


It is quite clear that if the current owner of a site could avoid liability merely by having purchased the site after the chemical dumping had ceased, waste sites certainly would be sold, following the cessation of dumping, to new owners who could avoid the liability otherwise required by CERCLA. Congress had well in mind that persons who dump or store hazardous waste sometimes cannot be located or may be deceased or judgment-proof. We will not interpret section [107(a)] in any way that apparently frustrates the statute's goals, in the absence of a specific congressional intention otherwise.

759 F.2d at 1045 (citations omitted).
to the defendant. If the responsible party cannot be located or is unable to finance the cleanup, the “Superfund” established by CERCLA will absorb the cost.

Unfortunately, CERCLA was a poorly worded compromise bill rushed through Congress in its closing hours due to the urgency of the problem and intensity of political pressure. One court, frus-

26. CERCLA § 107(b) provides:
   There shall be no liability under subsection (a) of this section for a person otherwise liable who can establish by a preponderance of the evidence that the release or threat of release of a hazardous substance and the damages resulting therefrom were caused solely by—
   (1) an act of God;
   (2) an act of war;
   (3) an act or omission of a third party other than an employee or agent or 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 concerned, taking into consideration the characteristics of such hazardous substance, in light of all relevant facts and circumstances, 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 omissions . . . .

In the 1986 amendments to CERCLA, the term “third party” defense in CERCLA § 107(b)(3) was clarified, making it explicit that there was no liability when a party can show that the release was caused solely by someone else, and due diligence was taken by the “innocent landowner” to determine the presence of hazardous material. See Pub. L. No. 99-499, § 101(35), 100 Stat. 1613, 1616-1617 (1986) (codified at 42 U.S.C. § 9601(35)(A) (Supp. IV 1986)); infra notes 35-44 and accompanying text (discussing the changes in the 1986 amendments which affected the use of “third party” defenses).


28. See supra note 18 and accompanying text; see also Artesian Water Co. v. New Castle County, 659 F. Supp. 1269, 1277 (D. Del. 1987) (stating that “[t]he federal government is authorized to use the Superfund to finance governmental response activities, to pay claims arising from response activities by private parties, and to compensate federal and state governmental entities for damage caused to natural resources.”) (citing CERCLA § 111(a), 42 U.S.C. § 9611(a) (1982)), aff’d, 851 F.2d 643 (3d Cir. 1988).

29. There were two separate bills which proceeded through the House and the Senate that dealt with the problem of toxic waste cleanup. The Senate bill contained major last minute alterations to insure that it would pass and the House bill was amended to conform with the Senate bill. The bill in its final form differed substantially from bills introduced earlier in the Senate and the House. Alexander, CERCLA 1980-1985: A Research Guide, 13 Ecology L.Q. 311, 312 (1986). See generally 1980 U.S. CODE CONG. & ADMIN. NEWS 6119 (reprinting the legislative history of CERCLA).

Although Congress worked on “Superfund” legislation for three years prior to the enactment of CERCLA, the actual bill has little published legislative history. F. Grad, TREATISE ON ENVIRONMENTAL LAW 1 (1981); Grad, supra note 15, at 1. It was put together by a bipartisan group of senators with some assistance from representatives and then was introduced and passed by the Senate in lieu of other pending bills on the same issue. Id. On December 3, 1980, “in the closing days of the lame duck session of an outgoing Congress,” the
trated over the original legislation, commented that "numerous 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." 30

In 1986, the Superfund Amendment and Reauthorization Act (SARA) 31 was enacted as a substantial amendment to CERCLA. 32 The amendment clarified many points which were unclear in the original legislation and attempted to increase the sophistication and effectiveness of the original legislation in light of current problems posed by hazardous materials. 33 It is expected that in light of SARA, there will be a dramatic increase in the number of federal actions for hazardous waste cleanup. 34

Although section 107 was essentially unchanged by the 1986 amendment, 35 the amendment added newly defined terms to section

---


35. See 42 U.S.C. § 9607 (1982 & Supp. IV 1986). One change in SARA is a federal lien provision. See id. § 9607(l) (Supp. IV 1986). This provision mandates that all costs and damages assessed to a liable entity under section 107 shall constitute a lien in favor of the United States. Id. § 9607(a) (1982). The purpose of this additional provision is to ensure that a landowner who benefits from Superfund dollars does not gain windfall profits from selling decontaminated property. H.R. REP. No. 253, 99th Cong., 1st Sess. 17, reprinted in 1986 U.S. CODE CONG. & ADMIN. NEWS 3038, 3040.
which helped clarify the vague language of section 107. One important clarification for lenders is the definition of "contractual relationship." Section 101(35)(A) of SARA provides a statutory exception to subsequent owner liability if the defendant acquires the facility after the hazardous waste disposal occurred and the defendant at the time of acquisition did not know or have reason to know of the disposal. The defendant, however, has an affirmative duty to inquire into the previous owner's activities in a manner "consistent

37. For example, it was unclear from the language of the original statute what constituted a contractual relationship. The legislative history of CERCLA strongly suggested that the contractual relationship exception to the third party defense was intended only to apply to contractors and other types of individuals. See 126 CONG. REC. 24,337 (Sept. 4, 1980) (statement of Rep. Gore); see also supra note 26 (discussing exceptions to CERCLA liability). Many cases which dealt with the definition of contractual relationships were in the context of work contractors rather than parties involved in real estate transactions. See, e.g., United States v. Ward, 618 F. Supp. 884, 897-98 (E.D.N.C. 1985) (holding that the third party defense was not applicable because the defendant was in a contractual relationship or an agent or employee with the transporter who was responsible for the illegal dumping); United States v. South Carolina Recycling & Disposal, 21 Envtl. Rep. Cas. (BNA) 1577, 1581 (D.S.C. 1984) (holding a landowner liable when there was a contractual relationship with a company storing contaminated barrels on the property). Nevertheless, one court commented in a footnote that, "[the buyer] appears to have a contractual relationship with the previous owners that blocks the [third-party] defense. The purchase agreement includes provisions by which [the buyer] assumed at least some of the environmental liability of the previous owners." New York v. Shore Realty Corp., 759 F.2d 1032, 1048 n.23 (2d Cir. 1985). Although the court failed to explain whether any contract of sale would prevent third party defenses, it was clear that the court was expanding the definition to alarming proportions.

38. SARA § 101(35)(A) provides:
   The term "contractual relationship", for the purpose of section [107(b)(3)] . . . includes, but is not limited to, land contracts, deeds or other instruments transferring title of possession, unless the real property on which the facility concerned is located was acquired by the defendant after the disposal or placement of the hazardous substance on, in, or at the facility, and one or more of the circumstances described in clause (i), (ii), or (iii) is also established by the defendant by a preponderance of the evidence:
   (i) At the time the defendant acquired the facility the defendant did not know and had no reason to know that any hazardous substance which is the subject of the release or threatened release was disposed of on, in, or at the facility.
   (ii) The defendant is a government entity which acquired the facility by escheat, or through any other involuntary transfer or acquisition, or through the exercise of eminent domain authority by purchase or condemnation.
   (iii) The defendant acquired the facility by inheritance or bequest.
In addition to establishing the foregoing, the defendant must establish that he has satisfied the requirements of section [107](b)(3)(a) and (b). . . .

39. Id.
40. Id. § 9601(35)(A)(i).
with good commercial or customary practice” to minimize liability.\(^{41}\)

This provision affects the affirmative “third party” defenses available under CERCLA\(^{42}\) and over time the courts will have to determine what constitutes “good commercial or customary practice”.\(^{43}\) It is clear, however, that in order to take advantage of the third party defense, there must be affirmative inquiry into whether there is hazardous material at the property site.\(^{44}\)

Both CERCLA and SARA interrelate with other environmental regulations. The most closely related federal legislation is the Resource Conservation and Recovery Act (RCRA), which was enacted in 1976.\(^{45}\) RCRA has been called “Cradle to Grave” legislation be-

---

41. *Id.* § 9601(35)(B). Section 9601(35)(B) describes the duty of inquiry for potential landowners as follows:

(B) To establish that the defendant had no reason to know . . . the defendant must have undertaken, at the time of acquisition, all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice in an effort to minimize liability. For purposes of the preceding sentence the court shall take into account any specialized knowledge or experience on the part of the defendant, the relationship of the purchase price to the value of the property if uncontaminated, commonly known or reasonably ascertainable information about the property, the obviousness of the presence or likely presence of contamination at the property, and the ability to detect such contamination by appropriate inspection.

Id.

42. *Id.* § 9607(b).

43. *Id.*

44. *Id.* § 9607(b)(3). In order for the statute to apply, the third party must (a) exercise “due care . . . in light of all relevant facts and circumstances, and (b) . . . [take] precautions against foreseeable acts or omissions of any such third party and the consequences that could foreseeably result from such acts or omissions.” *Id.* As one commentator noted:

[A] purchaser that averts its eyes from contamination . . . is unlikely to be able to invoke the [third-party] defense successfully.

In fact, a buyer must take affirmative steps to protect itself, and it is in the lender's interest to assure that a borrower takes such steps when purchasing property that may be contaminated. . . .

Whether such inquiry is appropriate depends on the buyer's specialized knowledge or experience, commonly known or reasonably ascertainable information about the property, and the ability to detect such contamination by appropriate inspection. The relationship of the purchase price to the value of the property if uncontaminated is important, too.


cause it was designed to oversee the use, transportation and disposal of hazardous material for the duration of the potential risk to persons or the environment by the material.\textsuperscript{46} Another relevant statute is the Hazardous and Solid Waste Amendment of 1984 (HSWA),\textsuperscript{47} which extended the power delegated to the EPA under RCRA.\textsuperscript{48}

B. Potential Lender Liability

Although lenders are not explicitly named in CERCLA as potential defendants, liability for the cleanup of hazardous waste disposal on property where the lender has a security interest may nonetheless occur. For example, a party with a contractual relationship with the party directly responsible for the disposal may be held liable under CERCLA.\textsuperscript{49} The rationale for this imposition of liability is that a party with a contractual relationship is presumed to have known or should have known\textsuperscript{50} of the activities causing the pollution.

\textsuperscript{46} G. DOMINGUEZ & K. BERTLETT, HAZARDOUS WASTE MANAGEMENT: THE LAW OF TOXICS AND TOXIC SUBSTANCES 80 (1986).


\textsuperscript{48} See 42 U.S.C. §§ 6901-6991 (Supp. IV 1986). The amendment was a means used by Congress to force the EPA to develop tougher standards and to close up loopholes which existed in the original legislation. See G. DOMINGUEZ & K. BERTLETT, supra note 45, at 51-78.

\textsuperscript{49} This liability is a rebuttable presumption under CERCLA § 107(b)(3), 42 U.S.C. § 9607(b)(3) (1982). A defendant held liable based upon the existence of a contractual relationship with the party directly responsible for the hazardous waste disposal must establish that he did not know nor had any reason to know of the disposal in order to take advantage of the "third party" defense. 42 U.S.C. § 9601(35)(B) (Supp. IV 1986); see supra notes 36-44 and accompanying text. This means that the defendant has an affirmative duty of inquiry, in a commercially sound manner, concerning the potential for hazardous waste contamination on the premises. 42 U.S.C. § 9601(35)(B) (Supp. IV 1986). This defense, therefore, requires that the prospective purchaser fully investigate the property prior to purchasing the premises because ignorance may not be a viable defense without some attempt to protect oneself. Klotz & Siakotos, Lender Liability under Federal and State Environmental Law: Of Deep Pockets, Debt Defeat and Deadbeats, 92 COMM. L.J. 275, 286 (1988).

\textsuperscript{50} Congress has taken the position that "[t]hose engaged in commercial transactions
and therefore had the capacity to prevent hazardous disposal.\footnote{Curiously, a lender may, under certain situations, be considered an "owner or operator"\footnote{See supra note 56.} of the property even without having title or taking possession of the premises.\footnote{One court interpreted an owner or operator for the purposes of CERCLA as "a person who owns interest in a facility and is actively participating in its management because of his control over its operation." Id.} One court interpreted an owner or operator for the purposes of CERCLA as "a person who owns interest in a facility and is actively participating in its management because of his control over its operation."\footnote{Id.}

It is clear that similar definitions of owner and operator are being formulated under CERCLA to impose liability. The third party defense may be very difficult for a lender to prove because of the necessity of showing that there was no constructive notice of the dumping activity for a party with a contractual relationship. See 42 U.S.C. § 9601(35)(B) (Supp. IV 1986). One commentator noted that the definition of a contractual relationship in SARA, see infra note 56 (defining "owner and operator"), changes the focus and the threshold standard in determining the applicability of a "third-party" defense. Comment, The Impact of the 1986 Superfund Amendments and Reauthorization Act on the Commercial Lending Industry: A Critical Assessment, 41 U. MIAMI L. REV. 879, 898 (1987) (authored by Steven B. Bass) (stating that "[u]nder section 101(35), the focus of the judicial inquiry shifts from an assessment of causation to an assessment of actual and constructive notice." (footnotes omitted)).

\footnote{In the case of an onshore facility or an offshore facility, [an owner or operator is] any person owning or operating such facility.” 42 U.S.C. § 9601(20)(A)(ii) (1982). This definition remained unchanged in SARA, and therefore, might have opened the doors for further expansion of the terms “owner” or “operator” by the courts.

\footnote{See infra notes 54-77 and accompanying text (discussing situations where a lender could be held liable for the actions of their borrower); see also United States v. Northeastern Pharmaceutical & Chem. Co., 579 F. Supp. 823, 846-850 (W.D. Mo. 1984) (expanding the definition of "owner and operator" to include all past owners and operators and suggesting potential liability under the statute to virtually any party intrinsically involved in the workings of the facility), aff'd in part, rev'd in part, 810 F.2d 726 (8th Cir.), cert. denied, 484 U.S. 848 (1987). One author has suggested: There is no limit under the statute to how far back in time an act by a former generator, owner, operator, or transporter which contributes to a current release or threat may have occurred in order for him to be liable. Similarly there is no guarantee that the treatment or disposal . . . today will not render the generator, owner, or operator liable many years in the future for extensive cleanup and remedial costs. Hall, The Problem of Unended Liability for Hazardous Waste Management, 38 BUS. L.AW. 593, 603 (1983).}

The potential for unlimited liability should be particularly troubling to lenders because, under certain circumstances, they may be held liable retroactively for lending practices of loans already made. In addition, the value of the collateral may be greatly reduced for outstanding loans because of a prior owner's mishandling of hazardous material.
Lenders should be especially concerned where they have been significantly involved in the activities of the business. As a general rule, the statutory "security interest" exception protects a lender from liability when merely holding the indicia of ownership as a method of protecting their security interest. If, however, the secured party is involved in managerial functions of the company, it may not be afforded the protection of the exception. It has been left to the courts to determine where to draw the line on the amount of managerial intervention a secured party may be allowed without giving rise to potential CERCLA liability.

The most alarming interpretation of potential lender liability for hazardous waste was in United States v. Mirabile. In Mirabile, the

55. See infra notes 57-64 and accompanying text.
56. 42 U.S.C. § 9601(20)(A) (1982). This section provides:
"(O)wner or operator" means . . . (ii) in the case of an onshore facility or and offshore facility, 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.

Id. (emphasis added).

The legislative history of the original CERCLA limited the definition of "owner" so as not to include someone "possessing indicia of ownership (such as a financial institution) who, without participating in the management or operation of a vessel or facility, held 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. 1016, 96th Cong., 2d Sess., pt. 2, at 36, reprinted in 1980 U.S. CODE CONG. & ADMIN. NEWS 6151, 6181. The House Report presented an example of what situation would not lead to a financial institution being considered an 'owner' under CERCLA. The report stated that "a financial institution which held title primarily to secure a loan but also received tax benefits as the result of holding title would not be an 'owner' as long as it did not participate in the management or operation of the vessel or facility." Id.

An example of how this statute works to protect the secured party is In re T.P. Long Chem., Inc., 45 Bankr. 278, 288-89 (N.D. Ohio 1985). T.P. Long held that a lender was not liable for the cleanup costs incurred by the EPA because the bank, BancOhio, held only a perfected security interest in the premises and clearly did not engage in managerial functions of the business. Id. at 288-89. The court also stated in dicta that even if BancOhio had foreclosed on the property, they would still not be held liable and would fall under the secured party exception of CERCLA § 101(20)(A). Id.

57. See infra notes 59-64 and accompanying text (explaining that a high level of involvement by a lender in the management of their borrowers may lead to CERCLA liability).
58. Compare T.P Long, 45 Bankr. at 289 (holding that even if the secured creditor had taken title to the premises, there would not be liability because the lender had not played any managerial role in the company) with United States v. Mirabile, 15 Envtl. L. Rep. (Envtl. L. Inst.) 20,994 (E.D. Pa. Sept. 4, 1985) (holding in part that a bank may have liability for hazardous waste cleanup because it played some managerial role). For further discussion of Mirabile, see infra notes 59-63 and accompanying text.
The court denied the motion, holding that the bank was potentially liable for hazardous waste cleanup under CERCLA based on the integral role the bank played in the management of its borrower. The court explained that liability would be imposed where the lender's participation extends to the "nuts-and-bolts, day-to-day production" of the borrower and where the lender participates in more than mere financial aspects of operations. Accordingly, a lender involved in the management of its borrower's business, to an extent greater than that which is essential to monitor the financial condition of the company, could potentially be faced with CERCLA liability.

This is disturbing for lenders since courts...
will be evaluating lending practices to determine if there is sufficient involvement with borrowers to trigger CERCLA liability.

Furthermore, a lender may also be held liable as an "owner or operator" if the lender forecloses on the property and does not immediately resell the premises. In United States v. Maryland Bank & Trust Co., the court stated that if the bank was not held liable when they hold property after foreclosure, the lender would be unjustly enriched by gaining property which the federal government had borne the cost of cleanup. The court concluded that the secur-

partner will lose the protection of limited liability. See Uniformed Limited Partnership Act § 17, 6 U.L.A. 601 (Master ed. 1969). Similarly, the lender who plays too close a role in the management of its borrower's business may arguably assume any liability for clean-up costs, where that borrower is responsible for hazardous waste.

Corporate shareholders and officers have potential secondary CERCLA liability similar to that of lenders. See, e.g., United States v. Northeastern Pharmaceutical & Chem. Co., 810 F.2d 726, 742-44 (8th Cir.) (holding that an officer who had direct supervision or arranged for the disposal and a stockholder who played an active role in management of the company were individually liable for CERCLA cleanup costs), cert. denied, 484 U.S. 848 (1987); United States v. Ward, 618 F. Supp. 884, 894-95 (E.D.N.C. 1985) (holding that a corporate officer who exercises authority on behalf of the corporation or who arranges for the disposal of the waste is liable for CERCLA cleanup costs). For further discussion of corporate liability, see Murphy, The Impact of "Superfund" and Other Environmental Statutes on Commercial Lending and Investment Activities, 41 BUS. LAW. 1133, 1145-52 (1986); Note, CERCLA Defendants: The Problem of Expanding Liability and Diminishing Defenses, 31 WASH. U.J. URB. & CONTEMP. L. 289, 298-300 (1987) (authored by Cynthia S. Korhonen & Mark W. Smith).

See infra notes 66-70 and accompanying text.

65. See infra notes 66-70 and accompanying text.

66. 632 F. Supp. 573 (D. Md. 1986). The bank had made various loans to the previous owner and when the son of the previous owner wanted to buy the family farm, the bank loaned him money as well. Id. at 575. A short time after the son bought the property, he stopped making loan payments and the bank began foreclosure proceedings. Id. Approximately a year after the foreclosure, the EPA inspected the property and discovered hazardous waste which was improperly disposed of on the property. Id. The United States, in turn, sued Maryland Bank for costs incurred in cleanup. Id. at 574-75

The court held that the bank was liable for cleanup costs because full title vested in the bank when they purchased the property at the foreclosure sale because the bank no longer had a security interest in the property. Id. at 579. Since the bank held the premises for an unreasonable length of time, the court held that they were precluded from claiming any exemption of payment. Id. at 579 n.5. The court made no mention of any possible activity the bank had engaged in while owning the site. The time period that would be considered reasonable for the lender to hold onto property after foreclosure is still an open issue. In light of Maryland Bank & Trust Co., however, it would be advisable for the lender to do an investigation of the property before foreclosure and to discard the property as soon after foreclosure as market conditions permit. Berz & Sexton, Lending into Hazardous Substance Liability: The Secured Creditor as "Owner" Under Superfund, 12 CHEM. WASTE LITIG. REP. 35, 45 (1986).

67. Maryland Bank & Trust Co., 632 F. Supp. at 580. The court, expressing its concern over the equity of the distribution of the cleanup costs, stated:

the federal government alone would shoulder the cost of cleaning up the site, while the former mortgagee-turned-owner . . . benefit[s] from the clean-up by the increased value of the now unpolluted land. At the foreclosure sale, the mortgagee
HAZARDOUS WASTE LIABILITY

ity interest which was afforded protection under CERCLA section 101(20)(A), 68 "terminated at the foreclosure sale . . . at which time it ripened into full title." 69 The court noted that lenders have means of protecting themselves by making prudent loans and argued that extra protection is not necessary. 70

Nevertheless, in the typical situation, where the lender forecloses with the intent to resell the facility and apply the proceeds to satisfy the outstanding debt, automatic liability should not be incurred. 71 The potentially dangerous time period for the lender is when the lender buys the property at a foreclosure sale in order to maximize its return, and hazardous waste is then discovered on the premises. This would greatly reduce the value of the property and may also force the lender to bear the costs of cleanup. 72

In defining "owner or operator" CERCLA makes an exception for a security interest in property. 73 If the creditor, however, becomes overly entangled in the affairs of the company, the exception will not be afforded to the creditor. 74 It is important for lenders to
could acquire the property cheaply. All other prospective purchasers would be faced with potential CERCLA liability, and would shy away from the sale. Yet once the property has been cleared . . . the mortgagee-turned-owner would be in a position to sell the site at a profit.

*Id.* at 580. Authors have argued that the court's rationale is flawed because CERCLA cleanup costs can be grossly disproportionate to the value of the property prior to the contamination. *See, e.g.*, Soriano & Lockett, *Hazardous Waste Liability: The Emerging Problem for Lenders*, 12 CHEM. WASTE LITIG. REP. 47, 57-58 (1986). It is furthered argued that "while it may be inappropriate to grant a lending institution a windfall at the government's expense, it may be equally inappropriate to penalize an innocent lending institution by imposing a liability the amount of which greatly exceeds the value of the land. . . ." *Id.*

70. *Id.* at 580. The court further commented that "[t]he mortgagees also have the options of not foreclosing and not bidding at the foreclosure sale. Both steps would apparently insulate the mortgagee from liability." *Id.* at 580 n.6. However, one obvious result of not foreclosing on the collateral is that the chance of recovering any amount owed on the loan would be greatly diminished, and possibly eliminated.
71. Berz & Sexton, *supra* note 66, at 44. The situation in *Maryland Bank & Trust Co.*, 632 F. Supp. at 573, is the atypical case. *See supra* notes 66-70 and accompanying text. Although under normal lending practices where the property would be sold as soon as possible after foreclosure, liability should not be incurred and precautions such as environmental auditing should be taken. *See infra* notes 91-149 and accompanying text (discussing environmental auditing and its use by lenders); *see also* Berz & Sexton, *supra* note 66, at 45-46.
72. *See supra* notes 66-70 and accompanying text.
73. CERCLA § 101(B)(20)(A), 42 U.S.C. §9601(20)(A) (1982) (providing 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."); *see supra* notes 54-56 and accompanying text.
74. *See supra* notes 59-64 and accompanying text (discussing the limitation of the third
recognize dangerous lending practices and either avoid or minimize the effect of these activities. Such practices include: (1) requiring clauses in the security agreement allowing a lender to approve managerial appointments; (2) requiring clauses in the security agreement allowing a lender to approve major business transactions of the borrower; (3) requiring clauses in the security agreement whereby a lender would provide “management assistance”; (4) hiring management consultants; and (5) being actually involved in manufacturing or design changes. Purely financial intervention such as (1) placing mandatory caps on dividends and salaries of officers of the borrower-corporation, (2) reserving the right to approve the purchasing of life insurance by the borrower for its employees, (3) general involvement in accounting and record keeping of the borrower, and (4) assistance with marketing and sales strategies and tactics that do not involve the production, storage, or disposal of hazardous waste, are likely to be insufficient activities to characterize the lender as an owner or operator. Potential liability could arise, however, when a lender places numerous conditions and restrictions in the loan agreement, even if all such conditions are financial in nature; abundant provisos made by the lender may be construed by a court as sufficient involvement to impose Superfund liability on the lender.

One option for a lender confronted with a borrower engaged in activities which may result in Superfund liability is to force the borrower into bankruptcy. The lender may see this as a means of avoiding potential liability while engaging in workout procedures or foreclosure. In Ohio v. Kovacs, the Supreme Court held that an injunction ordering the cleanup of a hazardous waste site could, in certain circumstances, give rise to a dischargeable claim in bankruptcy.

In a more recent case, however, the Supreme Court held that a party defense when the lender is in very close contact with the management of the borrower's business. See generally Burcat, supra note 15, at 513-24. 75. Berz & Sexton, supra note 66, at 41-42. 76. Id. at 42-43. 77. Id. at 43. In addition, liability may arise if the lender is generally involved in the financial affairs of a borrower corporation that is actually in the business of hazardous substances. See id. 78. Soriano & Lockett, supra note 67, at 59-60. 79. Id. 80. 469 U.S. 274 (1985). 81. Id. at 284-85. The Court noted, however, “that defendant's discharge will shield him from prosecution for having violated the environmental laws of Ohio or for criminal contempt for not performing his obligations under the injunction prior to bankruptcy.” Id. at 284.
HAZARDOUS WASTE LIABILITY

bankruptcy trustee may not abandon a hazardous waste site "in con-
travention of a state statute or regulation that is reasonably designed
to protect the public health or safety from identified hazards." Abandonment would not be permitted without formulating condi-
tions which would adequately protect the health and safety of the
public, even if the property was worth substantially less than the cost
of cleanup. It has been suggested that this result is based on the
reasoning that in some situations environmental considerations out-
weigh the "fresh start" policy of the Bankruptcy Code. Judicial
decisionmaking influenced by environmental concerns encumber the
debtor's estate and therefore reduce the secured creditor's potential
for recapturing its investment. As a consequence, there may be a
significant impact on lenders' business practices. In order to best
calculate the risks of an investment when a lender enters into a se-
curity arrangement, lenders must be aware of the possible effects
hazardous waste cleanup may have if a borrower files for bankruptcy.

82. Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection, 474 U.S. 494, 507
(1986). The Court explained the following:

This exception to the abandonment power vested in the trustee . . . is a narrow one.
It does not encompass a speculative or indeterminate future violation of such laws
that may stem from abandonment. The abandonment power is not to be fettered by
laws or regulations not reasonably calculated to protect the public health or safety
from imminent and identifiable harm.

Id. at 507 n.9. Although "Midlantic does not explicitly impose CERCLA (or the state law
equivalent) liability on a bankruptcy trustee or a debtor's estate . . . the decision accomplishes
the same result because it requires a trustee to use estate assets to clean up hazard waste
sites." Soriano & Lockett, supra note 67, at 62.

83. Midlantic Nat'l Bank, 474 U.S. at 507; see e.g. In re Wall Tube & Metal Products
Co., 831 F.2d 118, 124 (6th Cir. 1987) (holding that hazardous waste site response costs are
entitled to administrative expense priority where such costs are "actual and necessary" to pre-
serve the estate and protect the health and safety of the public).

84. See Soriano & Lockett, supra note 67, at 50.

85. Id. at 62. The impact of bankruptcy proceedings on hazardous waste litigation is
beyond the scope of this Note. For further discussion, see Drabkin, Moorman & Kirsch, Bank-
Inst.) 10,168 (1985); Environmental Compliance, Permitting and Cleanup Obligations: To
What Extent Should They Take Precedence Over Obligations During and After Bankruptcy?,
in DIV. FOR PUB. SERV., A.B.A., BURDENS OF ENVIRONMENTAL REGULATION ON
PRIVATE PROPERTY OWNERSHIP AND BUSINESS TRANSACTIONS: REASONABLE OR UNREASONABLE? 4
(1987); Schnapf, Environmental Cleanup Obligations and the Bankruptcy Trustee's Abandon-
ment Power: Dumping on the Creditor?, 59 N.Y. St. B.J., Oct. 1987, at 40; Note, Abandoning
Hazardous Waste Sites in Bankruptcy: Midlantic National Bank v. New Jersey Department
III. PROTECTION FROM LIABILITY FOR LENDERS

It is unrealistic for lenders to simply refuse to lend to borrowers who may later incur CERCLA liability.\(^6\) At the present time, this is especially true since many industries previously believed to be safe may, in fact, engage in activity which could result in future liability due to hazardous waste.\(^7\) Lenders cannot simply withdraw from financing commercial enterprises because this would cause lenders to give up a major source of business.\(^8\) This does not mean that lenders should continue traditional lending practices. Rather, lenders must safeguard and reduce their risk of liability in light of the potential exposure produced by the improper or accidental release of hazardous material.\(^9\) There are several methods a lender may use to protect itself, although none insure total immunity from potential future CERCLA liability.\(^9\)

A. Environmental Auditing

An environmental audit is an independent evaluation identifying existing environmental problems with an industrial site and facility.\(^9\) This formal assessment can assist in managing potentially hazardous environmental conditions within an industrial plant and determining a facility's compliance with applicable environmental laws.\(^9\) It is also useful in obtaining an objective evaluation of a plant in light of present environmental standards.\(^9\) The purpose of an environmental

---


\(^7\) Id. For example, one bank official commented that the bank financed the purchase of a wood processing plant which resulted in foreclosure. Id. As it turned out there was a hazardous waste site on the premises, and before the bank could sell the property, it was responsible for cleaning up a hazardous waste site on the premises. Id.

\(^8\) See id. Banks would be required to abstain from financing anything involving the debtor's estate. Id.

\(^9\) Malcolm T. Murray, President of the National Association of Bank Loan and Credit Officers, agrees that traditional lending practices should continue. Mr. Murray comments that "[i]nstead of forgoing [sic] the market, we have to learn how to deal with it." Id.

\(^9\) See infra notes 91-203 and accompanying text (discussing the various methods of protection available to a lender).

\(^9\) See Maurer, The Environmental Audit: A Management Tool, in IMPACT ON BUSINESS TRANSACTIONS: 1988, supra note 44, at 327, 329. "An environmental audit is a formal detailed appraisal conducted by or for an operational facility of a business to determine its compliance posture to current federal, state and local environmental laws and regulations." Id.


HAZARDOUS WASTE LIABILITY

report is to identify and confirm environmental hazards which exist on the premises.  

Environmental auditing is a "proactive" approach of hazardous waste maintenance which encourages early detection of environmental problems. This allows remediation as soon as possible. Since cleanup costs may be dramatically reduced by early detection, auditing is extremely cost-effective. To be successful, the audit should identify both the strengths and weaknesses in the environmental programs presently in place by the company. It is also essential to accurately document on-site conditions and operations.  

The environmental audit may also be used as a compliance mechanism, in addition to its use in identifying and correcting environmental hazards. The EPA believes that "[a]uditing serves as a quality assurance check to help improve the effectiveness of basic environmental management by verifying that management practices are in place, functioning and adequate." In a policy statement, the EPA warns that audits evaluate, but are not substitutes for, direct compliance activities such as obtaining permits, monitoring compliance, reporting violations to the EPA and keeping good records. The EPA's policy is to encourage voluntary use of auditing in order to maintain management's commitment to programs designed for en-

94. See id. at 2-3. An audit may help uncover both past practices which may have gone unnoticed by management and the location and identification of existing waste disposal so that future problems associated with the disposal may be assessed. Witmer, Environmental Audits in Connection with Property Purchases and Sales, in PRACTICING LAW INSTITUTE, THE IMPACT OF ENVIRONMENTAL REGULATIONS ON BUSINESS TRANSACTIONS-REAL PROPERTY TRANSFERS AND MERGERS AND ACQUISITIONS 287, 290 (1986) [hereinafter IMPACT OF BUSINESS TRANSACTIONS: 1986].

95. H.W. BLAKESLEE & T.M. GRABOWSKI, supra note 93, at 3.

96. Id. at 4.

97. Id. at 3.

98. Id.


102. Id.
Voluntary auditing may lead to the reform of compliance regulation, thereby allowing the private sector to self-regulate to a certain extent.

Several methodologies may be used to develop an effective environmental audit. Depending on the needs of the individual company and the complexity of potential environmental impacts, different techniques and levels of sophistication will be needed to assure a successful audit. The EPA believes that to ensure a successful audit, the audit must be performed by an independent auditing team of adequate size and the team must be trained for the particular job.

103. Id. 104. Palmisano, Environmental Auditing as a Management Information System, in Auditing Handbook, supra note 100, at 5-28. Palmisano states the following:

[The] EPA believes that private-sector environmental compliance assurance and auditing provide an opportunity for developing compliance regulatory reform. Simple logic dictates that as the private sector assumes greater responsibility for ensuring compliance with environmental regulations, the public-sector role could diminish. However, for this to become a reality, EPA would need to be assured of the acceptability and integrity of the private programs, i.e., the agency would need to establish characteristics of effective private-sector compliance-assurance programs.

In addition, companies would need assurance that these programs would not work to their disadvantage and that EPA would not use them to increase, rather than reduce, the regulatory burden.

105. Stoller, Environmental Audits, in Fifth Annual Environmental Law Symposium 108, 109 (Oct. 17-18, 1988) (on file at Hofstra Law Review). Hazardous waste "[s]ites can range from virgin land to a highly developed piece of industrial land that contains lagoons, waste dump sites, barrel storage, underground storage tanks, incinerators and wet processes." Id. Nonetheless, "while the scope of work for these two extremes would be very different . . . the approach is basically the same." Id.

106. Environmental Auditing Policy Statement, 51 Fed. Reg. 25,004, 25,006, 25,009 (1986). An auditing team must be tailored to the specific facility being monitored. Typically the team should include:

(1) technical personnel who understand the operation of the business and the nature of the potential contaminants;

(2) regulatory compliance staff who understand present and past compliance and disposal methods of wastes;

(3) lawyers to define legal requirements and to apply the terms to the business transaction;

(4) a team leader to coordinate and plan the audit.


One commentator has suggested that the need for an attorney may benefit the facility owner by providing attorney-client privilege for findings, thereby preventing the premature dissemination of confidential results to outside parties. Maurer, supra note 91, at 333; see also Levin, An EPA Response on Confidentiality in Environmental Auditing, 13 Envtl. L. Rep.
Management support is also essential for a successful auditing program. The EPA also believes that the objectives must be clearly defined and put in a concise, clear report. Furthermore, the data gathered must be sufficiently analyzed in order to achieve the stated objectives of the report.

Since strict compliance with existing laws may not adequately ensure against future liability, the audit should include a scrutiny of possible hazardous substances which are used at the site. Particular attention should be paid to substances known to be, or suspected to be carcinogens, as well as those which have acute toxic effects.

One method of auditing is a substance-by-substance analysis which identifies regulated substances and evaluates the risk and compliance obligations associated with each. This technique allows

---

(Envtl. L. Inst.) 10,346 (1983) (discussing the issues involved in confidentiality of environmental reports). A lender should be aware of this protection and require immediate notification of any findings in order to prevent the borrower from hiding behind the shield of attorney-client privilege.

108. Id. at 25,009.
109. Id. at 25,009. It is particularly important for lenders to follow the guidance of the EPA since the main concern for lenders is making sure their borrowers stay within the boundaries of the regulations set forth by the EPA. If the lender follows the guidance of the EPA and maintains that it does not know nor have reason to know of the hazard then the lender would most likely have a valid defense under SARA § 107(b), 42 U.S.C. § 9607(b) (Supp. IV 1986).

110. Vanderver, Environmental Auditing, in ENVIRONMENTAL LAW HANDBOOK 437, 444 (7th ed. 1983). Vanderver has noted that:
under Section 107 of CERCLA, generators of hazardous waste are now liable for the cost of cleaning up abandoned hazardous waste sites at which their waste was disposed of. The fact that the generator complied with all applicable legal requirements at the time the waste was deposited at the disposal site is . . . no defense to liability under this statute.

111. Id.
112. Id. at 445-46. Vanderver makes the following comments concerning the substance-by-substance method:
This method [of analysis] is particularly appropriate where applicable regulatory requirements focus on particular substances. . . . If any of the substances identified under . . . [statutes such as RCRA or CERCLA] are present at a facility, the audit can focus on whether they are managed in accordance with applicable requirements. In addition, if the audit is designed to identify potential future liabilities arising out of the currently lawful management of hazardous or toxic substances, the substance-by-substance approach is essential.

Id. Ideally, the removal, disposal or by-products of every material entering the facility should be accounted for in the audit. Maurer, supra note 91, at 338.
parties to identify substances present at the site, evaluate the fate of each substance tracked, and analyze the legal regulations in handling problem substances.\(^{113}\) In addition, since lenders are interested in future liability, an assessment of the potential future impacts of the substances should be made.\(^{114}\) Even if the tested substances are currently being managed in accordance with the law, a prediction of the long-term effects of the substance should be made to assure a thorough understanding of the risks involved with the material being used or discarded.\(^{115}\)

Another method of auditing is an analysis of the legal requirements consisting of a survey of environmental laws and regulations.\(^{116}\) The survey will result in a schematic approach including all environmental compliance requirements under federal and state statutes and regulations.\(^{117}\) The use of a checklist may be useful in this analysis.\(^{118}\) A checklist, however, merely gives baseline data which must then be evaluated.\(^{119}\) A matrix system may be used instead of a checklist in order to make the survey more elaborate.\(^{120}\) However, a

113. Vanderwerf, supra note 110, at 446.
114. Id.
115. See id.
116. See id. at 448-49.
117. Id. at 448. "This method evaluates compliance with legal requirements concerning management practices and prevention of environmental pollution." Id. at 449.
118. See Symposium, supra note 99, at 75-85. One checklist that has been suggested for a pre-acquisition audit includes:

I. General Issues for Investigation
   - Applicable Regulations
   - Enforcement History
   - Environmental Compliance Management
   - Insurance Issues

II. Documents for Review
    Should include permits, reports and records for the operation of regulated operations such as boiler, and incinerator operations and waste water disposal.

III. Observation checklist
    - Air Pollution Control
    - Water Pollution Control
    - Spill Prevention and Control
    - Solid and Hazardous Waste Management

Id. This checklist is merely an abbreviated sampling of what should be included. The most extensive checklist possible is a checklist which will allow a lender to effectively evaluate potential hazardous waste contamination on the sites of their borrowers and will allow a lender to most productively evaluate their risk of liability under CERCLA.

119. J. Heer & D.J. Hagerty, ENVIRONMENTAL ASSESSMENTS AND STATEMENTS 159 (1977). For an example of how baseline data can be evaluated, see id. at 159-63.
120. A matrix is a grid where quantitative estimates of numerous materials are analyzed for the impact of the materials in different situations. Id. at 156. An example of a matrix
matrix may suffer from the problem of inflexibility and may also limit the evaluation of secondary impacts of hazards. 121

Auditing through the use of a survey, using either a checklist or a matrix, is particularly useful in evaluating compliance with regulations concerning management practices. 122 Additionally, a survey may enhance the discovery of environmental pollution which would otherwise be missed through other methods of auditing. 123 Thus, a survey may be the favorable method of auditing for a lender because it evaluates legal requirements of the company and will identify non-compliance. 124

There are two other methods of auditing available. One is a unit process analysis which calls for an examination of each individual area of a plant to determine whether potential hazards exist in any of them and an identification of all points where pollutants are being discharged. 125 An alternative technique is an analysis of the methods of disposal utilized at the plant, done through the identification of air emission, water discharge and disposal of waste in or on land. 126 However, neither of these two techniques should be the lender's first choice because they involve the day-to-day handling of material, which may expose the lender to the possibility of liability. 127

Whichever method the lender chooses, the audit report should include: (1) a statement of the purpose of the report and the procedures used; (2) an indication of the scope of the work; (3) a review of the results; and (4) a list of conclusions and suggested solutions. 128

In addition to the environmental audit which should be performed on the premises to be used as collateral prior to entering into a security arrangement, 129 the lender should also require on-going

would be "[o]ne hundred possible activities ... listed in the matrix along one axis, with 88 possible impacts listed along the other axis. Thus, 8,800 interactions can be displayed or indicated by means of this matrix." Id.

121. See id. at 158.
122. Vanderver, supra note 110, at 449.
123. Id.
124. See id.
125. Id. at 446-47. "Each unit process is examined to determine whether it is a closed system, and if not, at what points within the system pollutants are routinely released or where they may be accidentally discharged." Id.
126. Id. at 448.
129. Pre-transactional audits are important in assisting lenders in making intelligent evaluations on the feasibility of loans. See generally Vanderver, supra note 110, at 437-43.
reports. This will ensure a good faith effort by the borrower to comply with regulations and to correct situations before a condition becomes so serious that it is no longer economically feasible for the borrower to effectuate the necessary cleanup. Because of the growing concern over environmental hazards, audits are likely to play a much greater role in future real estate transactions: "It is projected that environmental audits ... will be found next to the termite certificate and the deed of trust [or mortgage] in future property files."

The auditing program should also be evaluated and updated to reflect changes in personnel and regulations. "In keeping up-to-date, the program not only maintains its effectiveness, but also will create an accurate awareness of the current environmental status of all operations and reduce the potential for undesirable surprises."

When a lender is contemplating foreclosure proceedings, an environmental audit should be considered. The evaluation will help the lender make an informed business decision regarding the property. If the audit concludes hazardous waste is present or the potential for contamination is large, then the lender may choose not to foreclose or if the lender does foreclose, it may choose not to bid at the foreclosure sale. The audit at the time of foreclosure will allow the

130. See generally infra notes 131-32 and accompanying text (discussing the necessity of an on-going auditing process).
131. Id. at 442-43. While on-going reports help to assure that the situation is easily rectifiable, for certain conditions they may limit the necessary cleanup through early detection. See supra notes 94-104 and accompanying text (discussing the purpose and benefits of environmental audits). In addition, auditing will not protect against the sudden accidental release of hazardous material. However, this should be addressed through the procurement of adequate liability insurance on the premises. See infra notes 150-89 and accompanying text (discussing the use of insurance to protect lenders as well as its deficiencies). Auditing may, nevertheless, detect defects and damage to equipment, which may prevent the accident altogether and reduce costs considerably. See supra notes 94-99 and accompanying text.
132. Symposium, supra note 99, at 89. The body of environmental knowledge on which to base an auditing system is relatively new and therefore the auditing systems are still in their early formation. Huelsman, supra note 100, pt. 3, at 4. Because of all the new developments in regulating hazardous material and the new tougher enforcement policies undertaken by the EPA, auditing methods and demands are merely in their infancy. Id. Universities have begun extensive work in the area, and engineering and law schools have started offering specialized courses to begin to address the needs for the present and the future. See id.
134. Id.
135. See supra notes 65-72 and accompanying text (discussing possible liability resulting from a lenders holding of contaminated land for an extended period of time after foreclosure). Since the cost of cleanup may exceed the value of the property, it may actually be less expensive to sell the contaminated property than to pay for its cleanup—if a buyer could be
lender to know its position and best determine how to mitigate its losses.\textsuperscript{136}

Environmental auditing has a number of limitations and potential problems for the lender.\textsuperscript{137} One problem is that each report is a "snapshot" interpretation which may alter as changes occur in the plant, the regulations, and the standards over time.\textsuperscript{138} What were once believed to be safe procedures and substances may not be viewed as such in the future.\textsuperscript{139}

Another problem is that an audit can generate a large volume of data to be evaluated,\textsuperscript{140} which requires expertise in environmental science and environmental regulations in order for the analysis of the audit report to be meaningful.\textsuperscript{141} A lender will probably lack the necessary expertise. In addition, auditing should neither replace ongoing environmental awareness nor cause management to rely so heavily on the auditing that they become disassociated with environmental concerns at the site.\textsuperscript{142}

Moreover, the audit may be met with resistance by the potential borrower. The borrower may be concerned with the preservation of trade secrets, confidentiality of the audit findings, use of the audit results in civil litigation, and the possibility of future criminal prosecution due to the increased level of knowledge.\textsuperscript{143} These concerns,

\begin{footnotesize}
\footnote{136. See Vollmann, \textit{Double Jeopardy: Lender Liability Under Superfund}, 16 \textit{REAL EST. L.J.} 3, 18 (1987). Vollman comments that "[i]f the lender could become primarily liable as an owner or operator of the property, the lender may be better off forfeiting its collateral." \textit{Id}.}
\footnote{137. Friedman & Giannotti, supra note 133, at 375 (noting that without other management systems, auditing may lead to potential problems for the lender).}
\footnote{138. \textit{Id.} The audit, without other management systems, is a "limited aspect of effective environmental management." \textit{Id.; see also} Vandever \textit{supra} note 110 at 444 (noting that "[b]ecause a company's activities frequently change, as do the legal requirements which may apply to those activities, a snapshot audit is of relatively limited value."). \textit{But cf.} H.W. Blakeslee & T.M. Grabowski, \textit{supra} note 93, at 2. Blakeslee and Grabowski observe that an "audit . . . can be likened to preparing a plant environmental profile . . . [which] is complemented . . . by an examination of past activities and future liabilities. For this reason, it may not be entirely appropriate to call an audit an 'environmental snapshot in time.'" \textit{Id}.}
\footnote{139. This forces the lender to try to predict the future and calculate what will be considered safe procedures in years to come. Lenders do not usually have expertise in environmental issues and the evaluation of risks of future environmental hazards may be beyond the scope of lender knowledge. Although including future predictions in the audit will help, it can in no way be used as a true risk-minimizing factor. \textit{See supra} note 110 and accompanying text.}
\footnote{140. Witmer, \textit{supra} note 94, at 292.}
\footnote{141. \textit{Id.} at 293.}
\footnote{142. H.W. Blakeslee & T.M. Grabowski, \textit{supra} note 93, at 1-2. If management does not stay involved and informed about environmental concerns, the company may not attempt to resolve problems related to hazardous disposal and waste before they occur.}
\footnote{143. Maurer, \textit{supra} note 91, at 338-39.}
\end{footnotesize}
however, are not present in a number of industries where the risks of liability are relatively low. Moreover, if these concerns are raised by the borrower, the lender should be alerted to the possibility that the borrower may be trying to hide high risk activities which may lead to CERCLA liability.

Lenders should also be aware the use of auditing can be a double-edged sword. For example: (1) the lender's demand for environmental auditing may be considered unrelated to financial matters of the borrower, thereby increasing the chance of liability and (2) the lender's insistence that the borrower engage in continual environmental auditing may create a condition subsequent to the security contract which may prevent the lender from using a "third party" defense against liability under SARA. Furthermore, the EPA takes the position that "the existence of an auditing program does not create any defense to or otherwise limit, the responsibility of any regulated entity to comply with applicable regulatory requirements."

The implementation of an environmental auditing program is an attempt by lenders to further a defense under CERCLA section 107(b) that the lender had no reason to know of the violation. Nevertheless, if an audit is done but does not detect an existing problem, it could be argued that the lender had "reason to know" of the hazard but failed to use due diligence in detecting the problem. Furthermore, if a problem is detected, the lender cannot ignore such a problem and may be under an affirmative obligation to ensure that the trouble is resolved in order to preclude CERCLA liability.

144. See supra notes 54-64 and accompanying text (discussing the potential CERCLA liability if a lender becomes over involved in the management of its borrower).
145. See supra note 35-44 and accompanying text (discussing the possibility that the relationship between the borrower and the lender could be considered "contractual" within the meaning of SARA, thereby preventing a successful "third party" defense).
148. See Chesler, Environmental Provisions in Real Estate Contracts, in IMPACT ON BUSINESS TRANSACTIONS: 1986, supra note 94, at 311, 331. Chesler states the following:
The Superfund Amendments [SARA] specifically provide that for the defendant to show he had "no reason to know" of the problem, the defendant must have undertaken, at the time of the acquisition, all appropriate inquiry into previous ownership and uses of the property consistent with good commercial or customary practice in an effort to minimize liability.
Id.
149. See supra note 48 and accompanying text (discussing liability through a contractual relationship with the disposer of hazardous waste); cf. Angelo & Bergeson, supra note 92,
B. Insurance

The use of insurance as a viable means of protection against losses stemming from hazardous waste has changed since the implementation of SARA, which established statutory guidelines concerning alternative methods of insurance for landowners with high risk of waste contamination. Several kinds of insurance which protect against potential damage caused by hazardous material should be considered when requiring hazard insurance for prospective borrowers. Different insurance policies provide different coverage for hazardous waste and in certain industries special insurance is going to be needed to assure that cleanup costs and other liabilities are covered.

1. Comprehensive General Liability Insurance.— Comprehensive General Liability (CGL) insurance indemnifies the insured against loss caused by legal liability and covers damages as a result of "bodily injury" or "property damage" caused by an "accident" or "occurrence" which arises out of specific hazards.

---

150. SARA established guidelines for insurance and created new insurance groups such as "risk retention groups," which insure sites that were virtually uninsurable prior to the amendment of CERCLA. See 42 U.S.C. §§ 9671-9674 (Supp. IV 1986); infra notes 166-89 and accompanying text (discussing use of self insurance for businesses with high risk of hazardous waste).

151. See infra notes 152-70 and accompanying text (discussing the benefits and limitations of Comprehensive General Liability Policies); infra notes 171-78 and accompanying text (discussing the relative benefits and limitations of Environmental Impairment Liability policies); infra notes 179-84 and accompanying text (discussing the possible uses and problems with risk retention groups).

152. "Bodily injury" is defined as "bodily injury, sickness or disease sustained by any person which occurs during the policy period, including death at any time resulting therefrom." 2 R. LONG & M. RHODES, LAW OF LIABILITY INSURANCE § 10.05 (1986).

153. "Property damage" is typically defined in a policy as:
   (1) physical injury to or destruction of tangible property which occurs during the policy period, including the loss of use thereof at any time resulting therefrom, or
   (2) loss of use of tangible property which has not been physically injured or destroyed provided such loss of use is caused by an occurrence during the policy period.

_id_. § 10.05 (emphasis in original).

154. An "accident" is generally regarded as "a fortuitous event which is neither expected nor intended." _id_. § 10.04.

155. An "occurrence" is a term of art which is usually defined in the policy as "an accident, including continuous or repeated exposure to conditions, which results in bodily injury or property damage neither expected nor intended from the standpoint of the insured."

_id_. (emphasis in original).
Some courts have held that the dumping of hazardous waste and the resulting damages constitute an “occurrence” within the meaning of the CGL policy; therefore, the policy will cover such an incident.\textsuperscript{157} Environmental damage is generally considered “property damage” under CGL policies.\textsuperscript{158} CERCLA response costs, however, may or may not be considered covered “damages” under CGL policies.\textsuperscript{159} It

\textsuperscript{156} Id. § 10.01.

\textsuperscript{157} See, e.g., Mraz v. American Universal Ins. Co., 616 F. Supp. 1173 (D. Md. 1985) (holding that despite the fact that the chemicals were intentionally dumped, the leakage should be considered an occurrence within the meaning of the CGL policy in question since the damages were unexpected and unintentional), rev'd on other grounds sub nom., Mraz v. Canadian Universal Ins. Co., 804 F.2d 1325 (4th Cir. 1986). In Buckeye Union Ins. Co. v. Liberty Solvents and Chem. Co., 17 Ohio App. 3d 127, 477 N.E.2d 1227 (1984), the court held that “the ‘release or threatened releases’ of hazardous waste materials . . . are ‘occurrences’ within the common understanding of that term. Furthermore . . . [the] release of chemical substances into the environment were neither expected nor intended . . . .” Id. at 132, 477 N.E.2d at 1233.


\textsuperscript{159} There have been recent challenges by insurers to the inclusion of governmental cleanup costs within the meaning of “damages” under CGL policies. While several insurers have argued that the cleanup is equitable relief which would not constitute damages under the CGL policy, many courts have rejected this argument. See, e.g., Intel Corp. v. The Hartford Accident & Indem. Co., 692 F.Supp. 1171 (N.D. Cal. 1988) (holding that under California law, damages are compensation for the detriment suffered from an unlawful activity and that the state had, in fact, suffered a detriment and was entitled to damages); Township of Gloucester v. Maryland Casualty Co., 668 F. Supp. 394 (D.N.J. 1987) (holding that the cost of cleanup and closing of a landfill constitutes damages under a CGL policy). In Sharon Steel Corp. v. Aetna Casualty & Sur. Co., Nos. C-87-2306 & 2311, (Dist. Ct. Salt Lake County, Utah, June 20, 1988), the court held that:

\begin{quote}
[Defendant's attempt to distinguish damages as a substantial remedy from restitution as a restorative remedy is an artificial approach to determining the meaning of the word “damages” in these insurance contracts. Both restitution and damages are remedies seeking to compensate for a loss or an injury. . . . It would be unfortunate to construe the word “damages” in such a way to deny recovery when the subject property can be restored but allow recovery when compensation would be substantial for fortuitously destroyed property.]
\end{quote}

\textit{Id.} at 18.

Two circuits, however, have distinguished claims for damages from claims for injunctive and restitutionary relief. These courts have held that if the government cleans up the site and sues for the cost of cleanup, this is not money damages and is therefore not contemplated by the legal meaning of “damages” in the CGL policy. See Continental Ins. Co. v. Northeastern Pharmaceutical & Chem. Co., 842 F.2d 977 (8th Cir.) (reh’g en bane) (reversing prior decision and holding that cleanup costs are remediation expenses which are prophylactic in nature and thus are not “damages” as contemplated by the policy), cert. denied, 109 S. Ct. 66 (1988); Maryland Casualty Co. v. Armco, Inc., 822 F.2d 1348 (4th Cir. 1987) (holding that a claim against an insured for reimbursement of CERCLA response costs at a hazardous waste site does not constitute a claim for damages under the insured’s policy because the response costs are equitable in nature), cert. denied, 108 S.Ct. 703 (1988).
is also important to recognize that response costs may not be covered if either the resulting harm or the mandated cleanup does not occur during the policy period. This is likely since most "hazardous waste liability insurance . . . is almost exclusively underwritten on a 'claims made' basis" rather than "occurrence" coverage. This is extremely important to a lender because if CERCLA response costs are not covered by the insurance policy, the high cost of cleanup may damage the financial stability of the borrower.

Many CGL policies include a "Pollution Exclusion" clause which excludes from coverage losses due to pollution which are not caused by the "sudden and accidental" release of contaminants as well as losses caused by active polluters of the environment. If the

160. Continental Ins. Co. v. Northeastern Pharmaceutical & Chem. Co., 811 F.2d 1180 (8th Cir. 1987) (holding that the insurer had no duty to indemnify the insured if the cleanup costs were incurred after the policy period had ended), rev'd on other grounds, 842 F.2d 977 (reh'g en banc), cert. denied, 109 S. Ct. 66 (1988); Idaho v. Bunker Hill Co., 635 F. Supp. 665 (D. Idaho 1986) (holding that the insurer does not have the duty to indemnify the insured for releases during the policy period if the resulting harm did not occur until after the policy expires).

161. Parker, The Untimely Demise of the "Claims Made" Insurance Form?, 1983 Det. C.L. Rev. 25, 29. Insurance issued on an "occurrence" basis covers the insured against liability arising from any event occurring within the policy period, regardless of when such liability actually arises, while a "claims made" policy only protects the insured against claims actually filed against them during the policy period. See generally E. Holmes & W. Young, Cases and Materials on the Law of Insurance 365-67 (2d ed. 1985).

162. See supra note 21 (discussing the costs of cleanup of hazardous waste sites).


This coverage does not apply: . . . to bodily injury or property damages arising out of the discharge, dispersal, release or escape of smoke, vapor, . . . contaminants or pollutants into or upon land, the atmosphere or any water course or body of water; but this exclusion does not apply, if such discharge, dispersal, release or escape is sudden and accidental.


164. R. Long & M. Rhodes, supra note 152, § 10.15. There is a question as to whether the "sudden and accidental" language applies to the initial release of the pollutants or to the damages caused by the contaminants. See Hadzi-Antich, Coverage for Environmental Liabilities Under the Comprehensive General Liability Insurance Policy: How to Walk a Bull Through a China Shop, 17 Conn. L. Rev. 769, 795 (1985).

Two theories have evolved within the judiciary. The first is the "release theory," which focuses on the nature of the release of the substance into the environment. Note, Insurance Coverage for Superfund Liability: A Plain Meaning Approach to the Pollution Exclusion Clause, 27 Washburn L.J. 161, 172 (1987) (authored by Michael W. Peters). If the release was sudden and accidental from the viewpoint of the insured, then the pollution exclusion
clause is ambiguous, it must be interpreted in the light most favorable to the insured. This rule of construction may allow a reprieve for lenders who were unaware that such a clause was present in their borrower's insurance policy. In addition, the exclusion may not apply where the discharge occurred in the regular course of business or if the discharge occurred gradually over a long period of time. A pollution exclusion clause may also be inapplicable when the dumping was unintended and unforeseeable.

The duty of the insurer to defend the action is separate and distinct from the duty to indemnify. The insurer would have the


The second theory is the "damage theory," whereby a court focuses on the nature of the damages. Note, supra, at 197. If the insured did not know or had no reason to know that damage to the environment would occur as a result of the release of the pollutant, then the CGL policy would cover the damages. See, e.g., Jackson Township Mun. Util. Auth. v. Hartford Accident & Indem. Co., 186 N.J. Super. 156, 451 A.2d 990 (1982); Niagara County v. Utica Mut. Ins. Co., 103 Misc. 2d 814, 427 N.Y.S.2d 171 (1980), aff'd, 80 A.D.2d 415, 439 N.Y.S.2d 538 (1981).

165. Keene Corp. v. Insurance Co. of N. Am., 667 F.2d 1034, 1043 (D.C. Cir. 1981) (holding that when the policy language is ambiguous, it must be interpreted in a light most favorable to the insured and ordinary definitions of undefined words should be defined by looking to the context of the contract as a whole), cert. denied, 455 U.S. 1007 (1982).


167. See Pepper's Steel & Alloys, Inc. v. United States Fidelity & Guar. Co., 668 F. Supp. 1541 (S.D. Fla. 1987) (holding that the pollution exclusion clause was not relevant unless the damages were actually intended or at least substantially foreseeable). The court also found that the insured was not an "active polluter" since the company did not know of the release. Id. at 1548-49 (citing Payne v. United States Fidelity & Guar. Co., 625 F. Supp. 1189 (S.D. Fla. 1985)).

168. The duty to defend is broader than the duty to indemnify or pay damages. The insurer must defend an action whenever there is potential liability under the policy. See National Grange Mutual Ins. Co. v. Continental Casualty Ins. Co., 650 F. Supp. 1404, 1407-08 (S.D.N.Y. 1986); Casualty Reciprocal Exeh. v. Thomas, 7 Kan. App. 2d 718, 720, 647 P.2d 1361, 1363 (1982); Spruill Motors, Inc. v. Universal Underwriters Ins. Co., 212 Kan. 681, 684, 512 P.2d 403, 406 (1973). This means that the insurance company must defend the suit whenever a plaintiff advances any theory with the possibility of recovery and which arguably falls with the coverage provided, however remote the possibility of recovery. See United States Fidelity & Guar. Co. v. Thomas Solvent Co., 683 F. Supp. 1139, 1151 (W.D. Mich. 1988);
duty to defend the insured, even when a pollution exclusion clause is present, until it can be determined whether the release of pollution was excluded from coverage. The duty to defend, however, is not triggered until a suit has been brought against the insured.

2. Environmental Impairment Liability Insurance.—The uncertainty of coverage under a CGL policy may lead lenders to require borrowers who are at a high risk for hazardous substance releases to look to other forms of insurance. One special form of insurance is Environmental Impairment Liability (EIL) insurance, which would indemnify the insured from losses even if damages were not sudden and accidental. It is designed to cover third party damages caused by pollution on a “claim-made” basis.


169. Fireman’s Fund Ins. Co. v. Ex-Cell-O Corp., 662 F. Supp. 71, 76 (E.D. Mich. 1987). In determining the issue, “the burden is on the insurer to establish that some provision of the applicable policy excludes coverage under the facts as taken in the light most favorable to the insured.” Rothenberg, supra note 163, at 89. Most jurisdictions use the “comparison test” to determine whether a duty to defend exists. This “involves a side by side comparison of the provisions of the policy with the allegations contained in the complaint.” Del Tufo & Rohn, Environmental Liabilities and Insurance Coverage Issues: An Overview, in IMPACT ON BUSINESS TRANSACTIONS: 1988, supra note 44, at 561, 605.

170. See, e.g., City of Evart v. Home Ins. Co., No. 86-00419-ck (Mich Cir. Ct. Mar. 3, 1987) (granting summary judgment in favor of the insurer where the court held that there was no duty to defend before a suit is pending against the insured); Technicon Elec. Corp. v. American Home Assurance Co., 141 A.D.2d 124, 145, 533 N.Y.S.2d 91, 104 (1988) (holding that the “letter sent by the EPA . . . does not constitute institution of a ‘suit’ to recover such damages as that term is used in the subject policies so as to require a defense.” (citations omitted)); cf. Detrex Chem. Indus., Inc. v. Employers Ins. of Wausau, 681 F. Supp. 438, 442 (N.D. Ohio 1987) (ruling that there was no duty to defend since insuring language clearly differentiated between claims against the insured and suits against the insured). But see Ex-Cell-O Corp., 662 F. Supp. at 75 (holding that the duty to defend is triggered prior to the bringing of a traditional lawsuit). The court in Ex-Cell-O held that “suit includes any effort to impose on the policyholders a liability ultimately enforceable by a court.” Id.

171. Pollution liability was eliminated from virtually all CGL policies in 1986 and a new CGL policy was adopted by many companies which excluded from coverage both sudden and gradual pollution liability. Rodburg & Chesler, Beyond the Pollution Exclusion Clause: Emerging Parameters of Insurance Coverage for Hazardous Site Liability, 1986 CHEM. WASTE LITIG. REP. 324.

172. National Grange Mutual Ins. Co., 650 F. Supp. at 1404. EIL policies were intended to fill the gap created by the exclusion of coverage under CGL policies. See Telego, Environmental Impairment Liability (EIL) Insurance: Current Trends in the Marketplace: Future Trends and Impact of Government Action, 1985 LITIGATION/LIABILITY 383, 385. “[T]he need for pollution insurance has led to the development of a claims-made, nonsudden, gradual pollution damage policy. . . . [T]he EIL offers limited protection at high premiums and essentially covers remediation costs incurred with the carrier’s consent to reduce loss or to protect the property of a third party.” Del Tufo & Rohn, supra note 169, at 624-25.

173. Standards Applicable to Owners and Operators of Hazardous Waste Treatment,
The market for EIL has been growing but this form of insurance has also been plagued with unanticipated underwriting losses, ambiguous determinants of environmental risks and fears of further changes in environmental laws which could undermine the premises used in developing the policies. While the number of carriers offering EIL coverage has decreased considerably, the premiums have increased by more than two hundred percent. Although the future for EIL may appear questionable, insurance companies are apt to develop viable means of insuring the high risk group since the demand for coverage is increasing. Some experts and commentators believe that hazardous waste facilities will still be able to obtain insurance coverage even with the increased risk of large claims for the insurers. As market demand grows, competition for that market will also increase, leading to a revitalization of EIL or similar insurance.

3. Self Insurance.— The use of self insurance has begun

Storage, and Disposal Facilities: Liability Coverage, 50 Fed. Reg. 33,902, 33,904 (1985) [hereinafter Standards]. A “claim-made” basis means that the policy pays based on the individual claim and the requirements for that claim, rather than a set amount for particular types of claims which often have caps that are lower than the needed funds. Id. See generally T. Mallin, POLLUTION AND CONTAMINATION: HOW WILL PROPERTY INSURER’S RESPOND? 1 (1987).

174. Standards, supra note 173, at 33,904-05 (setting forth findings by the EPA).
175. Id. (discussing EPA findings regarding the conditions of the market for pollution liability insurance).

The number of insurance carriers offering EIL coverage decreased from thirteen in 1983 to three in 1985 and premiums increased 50 percent to 200 percent during that same period. It has been predicted that the already meager EIL market, which currently provides only about 5 percent of the demand for pollution liability coverage, will deteriorate further in the next few years. Id. (citation omitted).


178. Finlayson, supra note 177, at 44. At least one commentator has made the following observation:

In the absence of any indication that insurers regularly overestimate risks (a phenomenon that would be unlikely to persist in a competitive market for risks), there is no basis for projecting that hazardous waste facilities subject to stringent financial responsibility requirements would be unable to obtain coverage on terms that assign appropriate prices to the risks that these facilities create. Note, supra note 177, at 423.
through "Risk Retention Groups." These groups assume and spread the risk of CERCLA liability over all its members of the group thereby permitting high risk industries to insure themselves against hazardous waste contamination. Self insurance is provided for under SARA and gives a qualified preemption of state laws prohibiting this type of insurance. Self insurance may alleviate the problems arising out of the insurance industry's reluctance to insure companies with a high risk of toxic contamination. There is concern, nonetheless, that the opportunity for corruption exists within the groups. If the groups are not strictly regulated, risk retention groups could become severely undersecured, since one substantial claim could lead to the insolvency of the entire group. Although, the effect or feasibility of self insurance is not yet known, if properly managed, these groups could prove to be a viable alternative for insuring property that was previously believed to be virtually uninsurable.

4. General Considerations.—There are many uncertainties concerning the viability of insuring against CERCLA liability. Consequently, lenders must be aware of these limitations. Although a lender may think that an investment was safe because the lender required insurance, with different types of insurance and the varying interpretations of coverage, the actual protection for a lender is uncertain. In addition, a determination that coverage exists may only come after an extensive court proceeding which may tie up the insur-

179. SARA § 171 defines a "risk retention group" as "any corporation . . . whose primary activity consists of assuming and spreading all, or any portion, of the pollution liability of its group members. . . ." SARA § 171, 42 U.S.C. § 9671(3) (Supp. IV 1986).
180. See 42 U.S.C. § 9671 (Supp. IV 1986) (explaining that high risk industries will be eligible for risk retention groups under SARA).
185. See Abraham, supra note 183, at 942; Bauer & Lakind, Toward Resolution of Insurance Coverage Questions in Toxic Tort Litigation, 38 RUTGERS L. REV. 677 (1986); Note, Insurers' Liability Under CERCLA: Shifting Hazardous Waste Site Cleanup Costs to the Insurance Industry, 31 J. URB. & CONTEMP. L. 259 (1987) (authored by Joan Wart Gillespie); see also supra notes 152-70 and accompanying text (discussing benefits to and problems with CGL policies); supra notes 171-78 and accompanying text (discussing benefits to and problems with EIL policies); supra notes 179-84 and accompanying text (discussing possible uses of and problems with risk retention groups).
ance proceeds for a considerable length of time.

Furthermore, the lender is, to some extent, at the mercy of the borrower. The lender could lose its rights to the insurance proceeds if the policy did not cover the activity which caused the hazard. Although the lender might have a claim against the borrower, the borrower is likely to be insolvent at that point. Moreover, the property in which the lender has a security interest would be almost valueless because of the hazardous waste.\textsuperscript{186}

Prudent lending would require a lender to insist on hazard insurance. The lender, however, must additionally evaluate the policy to determine its terms and become familiar with the insurance laws of the jurisdiction—especially the judicial interpretation of the insurance policies and legislation.\textsuperscript{187} Further, the lender must evaluate which type of insurance is best suited for the type of plant being financed.\textsuperscript{188} One possibility is to first require an initial environmental audit\textsuperscript{189} and then, based on the evaluation of the audit, a more knowledgeable decision can be made to determine the type of insurance required.

\section*{C. Warranties and Representations}

Through a contractual agreement, a party may be released from liability for cleanup costs.\textsuperscript{190} Indemnification agreements for environmental liability have generally been held to be valid contractual relationships between private parties.\textsuperscript{191} The lender may include a warranty by the borrower in the security agreement that the property is free of hazardous materials and the mortgaged property will not be used for the manufacture, transportation, disposal or processing of hazardous materials, except in compliance with federal, state and lo-

\begin{itemize}
\item \textsuperscript{186} The lender may choose not to foreclose in the situation where there is a known contaminant on the premises because of the potential liability under United States v. Maryland Bank & Trust Co., 632 F. Supp. 573 (D. Md. 1986). \textit{See supra} notes 65-71 and accompanying text (discussing this potential liability).
\item \textsuperscript{187} \textit{See supra} notes 157-84 and accompanying text.
\item \textsuperscript{188} \textit{See supra} notes 152-84 and accompanying text (discussing the availability and limitations of CGL insurance, Environmental Impairment Liability insurance, and self insurance).
\item \textsuperscript{189} \textit{See supra} notes 91-149 and accompanying text.
\item \textsuperscript{190} \textit{See} Mardan Corp. v. C.G.C. Music Ltd., 804 F.2d 1454 (9th Cir. 1986) (holding that state law should govern the validity of cost recovery claims under CERCLA).
\end{itemize}
HAZARDOUS WASTE LIABILITY

The lender could require indemnification against environmental claims or liabilities arising out of the condition or use of the property regardless of fault, date of claim, type of damage, or amount of damage.\textsuperscript{193}

There are severe limitations on the effectiveness of warranties and indemnifications. A major problem with a warranty is that it is only meaningful if the party who signs it can effectively be held to its provisions. Unfortunately, by the time a lender would need to sue on the warranty, the borrower is likely to be judgment proof due to insolvency. Moreover, the lender may not want to foreclose on the property because it has been contaminated.\textsuperscript{194} If properly drafted, an indemnification might protect the lender from liability even if the property is foreclosed because of the "innocent landowner" exception from liability.\textsuperscript{195} The third party defense, however, may not be applicable since there is a contractual relationship between the liable party, the foreclosed borrower, and the lender/landowner.\textsuperscript{196}

Probably the most effective use of warranties are for businesses not currently using hazardous materials. The lender may preclude

\textsuperscript{192} Some representations and warranties which could be required include:

1. representation of the existence of all required permits and licenses;
2. compliance with all environmental laws, rules and regulations;
3. absence of pending claims, lawsuits and administrative proceedings, or investigations pertaining to environmental compliance;
4. accuracy of books and records supplied as part of an environmental investigation;
5. notice of any judicial or administrative proceeding into environmental compliance;
6. notification of the existence of any hazardous substance located at or in the premises;
7. knowledge of changes or events which will substantially alter the borrower's ability to comply with environmental laws or the ability to obtain necessary permits.


\textsuperscript{193} Representations and warranties may be very effective in a real estate transaction between a seller and a buyer. For a general discussion of warranties in real estate transactions, the impact SARA has had on contractual relationships, and examples of warranties which could be used, see Chesler, \textit{supra} note 148, at 311.


\textsuperscript{195} See \textit{supra} notes 52-58 and accompanying text (discussing the "innocent landowner" exception).

\textsuperscript{196} SARA § 107(b)(3), 42 U.S.C. § 9607(b)(3) (1982), specifically excludes the "innocent owner" defense when there is a contractual relationship with a liable party. See \textit{supra} notes 35-44 and accompanying text.
the business from engaging in activity which has potential CERCLA response repercussions and make this action a ground for default. Here the target group is not the high environmental risk borrower, but, rather the ordinary company which may regulate its own behavior if it knows that its loan will go into default if it engages in activity which involves the disposal of hazardous waste. The problem is that the borrower may not be aware that its activities could lead to improper disposal of hazardous waste.

D. **Affirmative Title Insurance**

The American Land Title Association has begun offering a special rider to the lender's title insurance policy insuring against any federal environmental protection liens and any state environmental protection liens197 which, at the date of the policy, are part of the public records.198 In addition, most title companies are requiring precautionary soil tests to determine the possible presence of toxic material as a precautionary measure and in light of the broad definition

197. The endorsement would state the following:
The Company insures the insured against loss or damage sustained by reason of lack of priority of the lien of the insured mortgage over:
(a) any environmental protection lien which, at Date of Policy, is recorded in those records established under state statutes at date of Policy for the purpose of imparting constructive notice of matters relating to real property to purchasers for value and without knowledge or filed in the records of the Clerk of the United States District Court for the district in which the land is located, except as set forth in schedule B; or
(b) any environmental protection lien provided for by any state statute in effect at Date of Policy, except environmental protection liens provided for [in the state statutes listed below] . . .

American Land Title Association (ALTA) form 8.1, Environmental Protection Lien Endorsement (rev. June 1, 1987).

198. Id. Public records are defined as:

[R]ecords established under state statutes at Date of Policy for the purpose of imparting constructive notice of matters relating to real property to purchasers for value and without knowledge. . . ."[P]ublic records" shall also include [for the purpose of this exclusion from coverage] environmental protection liens filed in the records of the clerk of the United States district court for the district in which the land is located.

Id.

HAZARDOUS WASTE LIABILITY

A Connecticut court has ruled that since title insurance is a single liability insurance (protecting only one hazard), it is limited to protection against loss due to defects or encumbrances of title which exist at the time the policy is issued. Therefore, title insurance may only provide indemnity for losses due to past occurrences rather than for unforeseen future losses. Under this analysis, response costs not existing at the time the title insurance is issued would not be covered under the policy.

Moreover, the title company would not be liable for a lien which is not filed prior to the effective date of the policy, even if the lien is present at the time of policy issuance. The title company may, however, be required to indemnify the insurer/lender if the title company had reason to know about the lien.

The lender should not rely on title insurance as a viable means of protection against liability for hazardous waste in light of the above shortcomings. Although it can protect the lender to the extent that the lender is assured there are no liens filed at the time the mortgage is executed, it cannot assure against subsequently filed liens. It should also be noted that, unfortunately for lenders, most liens do not appear until after the issuance of a policy thereby severely limiting the effectiveness of title insurance as a viable means of protection.


201. Id. at 543.

202. South Shore Bank v. Stewart Title Guar. Co., 688 F. Supp. 803, 805 (D. Mass. 1988); cf. Chicago Title Ins. Co. v. Kumar, 24 Mass. App. Ct. 53, 506 N.E.2d 154 (1987) (holding that a purchaser cannot be indemnified by the title insurance company for an unfiled lien, even if it was a valid lien which the seller knew existed at the time of the transfer of title); see also In re Lawyers Title Ins. Corp., No. RD 86-22 (Conn. Ins. Dep't 1987), reprinted in Beasley, supra note 199, at 537, 550 (holding that insuring against the existence of encumbrances of record whether in the land records or in the records at the state EPA would be "a risk of future loss created by the potential subordination of the lender's mortgage to the environmental lien of the State . . . [which] would constitute an impermissible assumption of casualty risk, outside the lawful business of title insurance.").

203. For example, if the seller reveals to the title company the possible existence of a problem on the premises with improper disposal of hazardous products, the title company may then be liable because they were made aware of the potential of a lien on the premises. See, e.g., Note, Hidden Hazards of Hazardous Waste Cleanup Laws: Lenders & Title Insurers Beware, 18 CUMB. L. REV. 723, 739-40 (1988) (authored by Virginia L. Martin) (discussing potential liability of title insurers).
of protection and producing a false sense of security on the part of the lender. 204

IV. CONCLUSION

Although none of these prophylactic measures alone is sufficient to protect a lender from CERCLA liability, using two or more of these measures in conjunction may sufficiently minimize the lender's risk of future liability. The level of scrutiny given to a loan with regard to the potential for hazardous waste liability and the amount of additional interest, if any, the lender requires in protecting against environmental liability, will depend on the particular loan and the collateral being used to secure the loan. In the situation where a borrower is not directly involved with businesses which use or produce hazardous materials, it may be sufficient to require warranties and possibly an initial pre-loan audit to determine if the property has existing problems of which the borrower may not be aware. On the other hand, a business which regularly uses, transports or disposes of hazardous materials would require much more careful scrutiny, and accordingly, some borrowers may be characterized as too great a risk for the lender to enter into any security arrangement.

A lender might require (1) affirmative title insurance, 205 (2) warranties, 206 (3) special hazardous waste insurance such as EIL, 207 or if that is not available, self insurance through membership in a risk retention group, 208 and (4) environmental auditing, including pre-loan auditing, periodic auditing during the life of the loan, and an audit before the lender takes any action to foreclose on the property. 209 These protective mechanisms will reduce, but not eliminate, the risk of liability for lenders arising from the release of hazardous materials into the environment.

Laura E. Peck

204. See supra notes 200-02 and accompanying text.
205. See supra notes 197-203 and accompanying text.
206. See supra notes 190-96 and accompanying text.
207. See supra notes 171-78 and accompanying text.
208. See supra notes 179-84 and accompanying text.
209. See supra notes 90-149 and accompanying text.