FEDERAL RESERVE BANK OF NEW YORK

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CHESTER B. FELDBERG
EXECUTIVE VICE PRESIDENT

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TO THE CHIEF EXECUTIVE OFFICERS OF
ALL STATE MEMBER BANKS, BANK HOLDING COMPANIES,
AND DOMESTIC OFFICES OF FOREIGN BANKS
IN THE SECOND FEDERAL RESERVE DISTRICT

SUBJECT: ENVIRONMENTAL LIABILITY

In recent years, banking organizations have become increasingly exposed to liability associated with the clean-up of hazardous substance contamination pursuant to the federal superfund statute, The Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA"). The superfund statute is the primary federal law dealing with hazardous substance contamination. However, there are numerous other federal statutes, as well as state statutes, that establish environmental liability that could place banking organizations at risk. Recent court decisions have provided a wide array of interpretations as to whether banking organizations are owners or operators of contaminated facilities, and thereby liable under the superfund statute for clean-up costs.

Banking organizations may encounter losses arising from environmental liability in a variety of ways. Of greatest concern are situations where banking organizations may be held directly liable for cleaning-up hazardous substance contamination by virtue of their ownership, through foreclosure or otherwise, of contaminated real property, or by virtue of their participation in the day-to-day management of such property. Losses to banking organizations can also result if the costs of clean-up of hazardous substance contamination impair the borrower's ability to service its loan, or materially affect the value of a bank's collateral.

Given the growing potential for environmental liability, banking organizations should have in place adequate safeguards and controls to limit their exposure. Enclosed is a discussion paper on environmental liability, including its impact on the activities of banking organizations. The paper, prepared by staff of the Board of Governors of the Federal Reserve System, is intended to provide an overview of the issues surrounding environmental liability, and to assist bankers in

evaluating the measures that can be taken to identify and minimize potential environmental liability. Any questions or comments about the foregoing should be directed to Barbara A. Klein, Assistant Chief Examiner, Domestic Examinations at (212) 720-8324 or Thomas P. McQueeney, Assistant Chief Examiner, International Examinations, at (212) 720-7934.

Yours sincerely,

Chester B. Feldberg

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Enclosure (1)

ENVIRONMENTAL LIABILITY

Background

In 1980, the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") was enacted in response to the growing problem of improper handling and disposal of hazardous substances. CERCLA authorizes the Environmental Protection Agency ("EPA") to clean-up hazardous waste sites and to recover costs associated with the clean-up from entities specified in the statute.

The relevant provisions of CERCLA, the so-called "superfund" statute, as it pertains to banking organizations, indicate which persons or entities are subject to liability for clean-up costs of hazardous substance contamination. These include ". . . the owner and operator of a vessel or a facility, (or) 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 . . . ."[1] A person or entity that transports or arranges to transport hazardous substances can also be held liable for cleaning-up contamination under the superfund statute.

The liability imposed by the superfund statute is strict liability which means the government does not have to prove that the owners or operators had knowledge of or caused the hazardous substance contamination. Moreover, liability is joint and several, which allows the government to seek recovery of the entire cost of the clean-up from any individual party that is liable for those clean-up costs under CERCLA. In this connection, CERCLA does not limit the bringing of such actions to the EPA, but permits such actions to be brought by third parties.

CERCLA provides a secured creditor exemption in the definition of "owner and operator" by stating that these terms do 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."[2] However, this exception has not provided banking organizations with an effective "safe harbor" because recent court decisions have worked to limit the application of this exemption. Specifically, courts have held that actions by lenders to protect their security interests may result in the banking organization "participating in the management" of a vessel or facility, thereby voiding the exemption. Additionally, once the title to a foreclosed property passes to the banking

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[1]CERCLA, Section 107(a).

[2]CERCLA, Section 101(20)(A).

organization, courts have held that the exemption no longer applies and that the banking organization is liable under the superfund statute as an "owner" of the property. Under some circumstances, CERCLA may exempt landowners who acquire property without the knowledge of preexisting conditions (the so-called "innocent landowner defense"). However, the courts have applied a stringent standard to qualify for this defense. Because little guidance is provided by the statute as to what constitutes the appropriate timing and degree of "due diligence" to successfully employ this defense, banking organizations should exercise caution before relying on it.

The superfund statute is the primary federal law dealing with the clean-up of hazardous substance contamination. However, there are numerous other federal statutes as well as state statutes that establish environmental liability that could place banking organizations at risk. For example, underground storage tanks are also covered by separate federal legislation.[3]

Overview of Environmental Hazards

Environmental risk can be characterized as adverse consequences resulting from having generated or handled hazardous substances, or otherwise having been associated with the aftermath of subsequent contamination. The following discussion highlights some common environmental hazards, but by no means covers all environmental hazards.

Hazardous substance contamination is most often associated with industrial or manufacturing processes that involve chemicals or solvents in the manufacturing process or as waste products. For years, these types of hazardous substances were disposed of in land fills, or just dumped on industrial sites. Hazardous substances are also found in many other lines of business. The following examples demonstrate the diverse sources of potential hazardous substance contamination which should be of concern to banking organizations:

- Farmers and ranchers (use of fuel, fertilizers, herbicides, insecticides, and feedlot runoff).
- Dry cleaners (various cleaning solvents).
- Service station and convenience store operators (underground storage tanks).
- Fertilizer and chemical dealers and applicators (storage and transportation of chemicals).

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[3]Resource Conservation and Recovery Act of 1986 (RCRA).

- Lawn care businesses (application of lawn chemicals).

- Trucking firms (local and long haul transporters of hazardous substances such as fuel or chemicals).

The real estate industry has taken the brunt of the adverse affects of hazardous waste contamination. In addition to having land contaminated with toxic substances, construction methods for major construction projects, such as commercial buildings, have utilized materials that have been subsequently determined to be hazardous, resulting in significant declines in their value. For example, asbestos was commonly used in commercial construction from the 1950s to the late 1970s. Asbestos has since been found to be a health hazard and now must meet certain federal and, in many instances, state requirements for costly removal or abatement (enclosing or otherwise sealing off).

Another common source of hazardous substance contamination is underground storage tanks. Leaks in these tanks not only contaminate the surrounding ground, but often flow into ground water and travel far away from the original contamination site. As contamination spreads to other sites, clean-up costs escalate.

Impact on Banking Organizations

Clearly, the greatest risk to banking organizations of the superfund statute and other environmental liability statutes is the possibility of being held solely liable for costly environmental clean-ups. If a banking organization is found to be a responsible party under CERCLA the banking organization may find itself responsible for cleaning-up a contaminated site at a cost that far exceeds any outstanding loan balance. This risk of loss results from an interpretation of the superfund statute as providing for joint and several liability. Any responsible party, including the banking organization, could be forced to pay the full cost of any clean-up. Of course, the banking organization may attempt to recover such costs from the borrower, or the owner if different than the borrower, provided that the borrower or owner continues in existence and is solvent. Banking organizations may be held liable for the clean-up of hazardous substance contamination in situations where the banking organization:

- Takes title to property pursuant to foreclosure;

- Involves the banking organization's personnel or contractors engaged by the bank in day-to-day management of the facility;

- Takes actions designed to make the contaminated property salable, possibly resulting in further contamination;

- Acts in a fiduciary capacity, including management involvement in the day-to-day operations of industrial or commercial concerns, and purchasing or selling contaminated property;

- Owns existing, or acquires (by merger or acquisition), subsidiaries involved in activities that might result in a finding of environmental liability;

- Owns existing, or acquires for future expansion, premises that have been previously contaminated by hazardous substances. For example, site contamination at a branch office where a service station having underground storage tanks once operated. Also, premises or other real estate owned could be contaminated by asbestos requiring costly clean-up or abatement.

A more common situation encountered by banking organizations has been where real property collateral is found to be contaminated by hazardous substances. The value of contaminated real property collateral can decline dramatically, depending on the degree of contamination. As the projected clean-up costs increase, the borrower may not be able to provide the necessary funds to remove contaminated materials. In making its determination whether to foreclose, the banking organization must estimate the potential clean-up costs. In many cases this estimated cost has been found to be well in excess of the outstanding loan balance, and the banking organization has elected to abandon its security interest in the property and write-off the loan. This situation occurs regardless of the fact that the superfund statute provides a secured creditor exemption. Some courts have not extended this exemption to situations where banking organizations have taken title to a property pursuant to foreclosure. These rulings have been based on a strict reading of the statute that provides the exemption to "security interests" only.

Another risk to banking organizations resulting from environmental liability stems from borrowers being operators, generators, or transporters of hazardous substances. Banking organizations must be aware that a borrower's solvency can be threatened by being found liable for cleaning-up hazardous substance contamination. Therefore, ultimate collection of loans to fund operations, or to acquire manufacturing or transportation equipment can be jeopardized by the borrower's generating or handling hazardous substances in an improper manner. Further,

some bankruptcy courts have required clean-up of hazardous substance contamination prior to distribution of a debtor's estate to secured creditors.

Borrowers may have existing subsidiaries or may be involved in merger and acquisition activity that may place the borrower at risk for the activities of others that result in environmental liability. Some courts have held that for the purposes of determining liability under the superfund statute, the corporate veil may not protect parent companies that participate in the day-to-day operations of their subsidiaries from environmental liability and court imposed clean-up costs. Additionally, borrowers can be held liable for contamination which occurred prior to their owning or using real estate.

Protection Against Environmental Liability

Banking organizations have numerous ways to identify and minimize their exposure to environmental liability. Because environmental liability is relatively recent, procedures used to safeguard against such liability are evolving. The following discussion briefly describes methods currently being employed by banking organizations and others to minimize potential environmental liability.

Banking organizations should have in place adequate safeguards and controls to limit their exposure to potential environmental liability. Loan policies and procedures should address methods for identifying potential environmental problems relating to credit requests as well as existing loans. The loan policy should describe an appropriate degree of due diligence investigation required for credit requests. Borrowers in high-risk industries or localities should be held to a more stringent due diligence investigation than borrowers in low-risk industries or localities. In addition to establishing procedures for granting credit, procedures should be developed and applied to portfolio analysis, credit monitoring, loan workout situations, and--prior to taking title to real property--foreclosures. Banking organizations may avoid or mitigate potential environmental liability by having sound policies and procedures designed to identify, assess and control environmental liability.

At the same time, banking organizations must be careful that any lending policies and procedures, but especially those undertaken to assess and control environmental liability, cannot be construed as taking an active role in participating in the management or day-to-day operations of the borrower's business. Activities which could be considered active participation in the management of the borrower's business, and therefore subject the bank to potential liability, include, but are not limited to:

- having bank employees as members of the borrower's board of directors or actively participating in board decisions;

- assisting in day-to-day management and operating decisions; and

- actively determining management changes.

These considerations are especially important when the banking organization is actively involved in loan workouts or debt restructuring.

The first step in identifying and minimizing environmental risk is for banking organizations to perform environmental reviews. Such reviews may be performed by loan officers or others, and typically identify past practices and uses of the facility and property, evaluate regulatory compliance, if applicable, and identify potential future problems. This is accomplished by interviewing persons familiar with present and past uses of the facility and property, reviewing relevant records and documents, and visiting and inspecting the site.

Where the environmental review reveals possible hazardous substance contamination, an environmental assessment or audit may be required. Environmental assessments are made by personnel trained in identifying potential environmental hazards and provide a more through review and inspection of the facility and property. Environmental audits differ markedly from environmental assessments in that independent environmental engineers are employed to investigate, in greater detail, those factors listed previously, and actually test for hazardous substance contamination. Such testing might require collecting and analyzing air samples, surface soil samples, subsurface soil samples, or drilling wells to sample ground water.

Other measures used by some banking organizations to assist in identifying and minimizing environmental liability include: obtaining indemnities from borrowers for any clean-up costs incurred by the banking organization, and including affirmative covenants in loan agreements (and attendant default provisions) requiring the borrower to comply with all applicable environmental regulations. Although these measures may provide some aid in identifying and minimizing potential environmental liability, they are not a substitute for environmental reviews, assessments and audits, because their effectiveness is dependent upon the financial strength of the borrower.

Conclusion

Potential environmental liability can touch on a great number of loans to borrowers in may industries or localities. Moreover, nonlending activities as well as corporate affiliations can lead to environmental liability depending upon the nature of these activities and the degree of participation that the parent exercises in the operations of its subsidiaries. Such liability can result in losses arising from hazardous substance contamination because banking organizations are held directly liable for costly court ordered cleanups. Additionally, the banking organization's ability to collet the loans it makes may be hampered by significant declines in collateral value, or the inability of a borrower to meet debt payments after paying for costly clean-ups of hazardous substance contamination.

Banking organizations must understand the nature of environmental liability arising from hazardous substance contamination. Additionally, they should take prudential steps to identify and minimize their potential environmental liability. Indeed, the common thread to environment liability is the existence of hazardous substances, not types of borrowers, lines of business, or real property.