

Lenders Liability of Commercial Banks in Environmental Tort: Focusing on American Law

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Abstract

With the deterioration of the environment and increasingly seriously environmental damage, the spread of the environmental responsibility scope is one of means to respond environmental crises. The federal Comprehensive Environmental Response, Compensation and Liability Act 1980 (CERCLA of US) imposed strict and joint liability to commercial banks and made them first become the main principle of liability in the environment tort. The systems of the environmental lender liability in US indicate that any person who "holds indicia of ownership primarily to protect the security interest" in a vessel or facility and provides that this person will not be liable as an owner or operator if the person does not "participate in the management" of the facility or vessel. Otherwise, commercial banks will be identified as the responsible party for the cleanup and reimbursement of costs associated with releases of hazardous substances. The lender environmental liability systems haven't been established in China. It is the nip in the bud to comprehensively cognize the systems environmental lender liability of US.

Keywords: Commercial banks, Lenders, Environmental liability, Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)

1. Introduction

According to a survey conducted by Environmental Data Resources Inc. (EDR) in 2003, one out of every ten banks involved in commercial estate loans had experienced losses due to environmental issues within the past year. The environmental-related losses involved an average of two loans per year and the average total loss was \$1.2 million. Based on the number of banks involved in commercial real estate transactions, EDR said the survey meant that 900 banks may have experienced losses due to environmental issues during the preceding twelve months and that the total value of these defaulted loans could be \$1.11 billion (Lawrence P. Schnapf, 1998, P.146). On the one hand, the loss of commercial banks roots in that lenders' cash flow is impacted because of environmental issues, and their loan repayment capacity is reduced, so the anticipated income of commercial banks deviates from the actual income. On the other hand, some commercial banks are identified as the owner or manager of pollutions, and they have to undertake the legal responsibility of environment tort. For the former, the loss of banks is indirect, but for the latter, banks are the direct responsibility because of loans.

Commercial banks are not the direct generators and dischargers of environmental pollution, but why they should be responsible for lenders' behaviors? In the threats of environmental crisis to human survival and development, to prevent the deterioration of the environment, it has been the focus to solve the environmental pollutions, and the expansion of the environmental legal liability principle and the extension of the undertaking range are effective measures. The CERCLA passed by the US Congress in 1980 was the law breaking the traditional concept of the environment damage civil liability system, and the relative parties' joint liability and strict liability, and the retroactive force of legal effect confirmed by this law made banks undertake the direct environment legal liability of the environment pollution because of the causes from themselves, but the indirect legal liability of lenders.

The main intention of CERCLA was to clean the "brownfields" in the whole US and confirm the undertakers of cleaning pollutions, but the item of strict liability confirmed by this law made the loan banks face potential environment cleanness liability (Dawn A. Baumholtz, 1998, P.67, 73). Though there were many disputes since this law was born, but most scholars still supported the bank liability in the environment tort because just the capitals of loan banks supported the environmental tort behaviors, and loan banks acquire considerable incomes from these behaviors, and loan banks generally have sufficient capitals to undertake the charges of cleaning pollution, and the identity of the lender of commercial banks makes them have sufficient capacity to survey and

control that borrowers abide relative regulations in the environment law. By integrating many factors such as politics, economics, and laws, loan banks should undertake the civil liability of environment (R.M. Auerback, 1995).

The biggest environmental impact of private financiers is not their own ecological footprint, but their strategic role in allocating capital to other businesses (William L. Thomas, 2001, P.899). At present, the environmental liability system of Chinese commercial banks lenders has not be established, and the environmental liability risk consciousness of commercial banks has not been formed, so when the commercial banks of China begin to expand to the overseas, it is very necessary to clearly and comprehensively cognize the representative environmental liability system of US loan banks.

2. Basic systems

The CERCLA didn't aim at the environmental loans of commercial banks, but the regulation about relative potentially responsible parties was not sufficient, i.e. the justice had sufficient carrying space to evolve commercial banks. To prevent the infinite expansion of the environmental responsible parties, this law included lenders' liability exemption which could provide the safe harbor for lenders to avoid hurting innocent lenders, but the land banks must accord with certain conditions, and the liability exemption in this law was not applicable in other federal laws. Therefore, loan banks can not rest easy in the safe harbor, but will draw fire against them once they are not careful.

2.1 Environmental civil liability parties and defences

CERCLA regulated four potentially responsible parties should undertake charges of cleaning and compensation for hazardous matters. These four potentially responsible parties include (1) past and current owners of facilities and vessels such as tanks, equipment, etc; (2) past and current operators of facilities and vessels; (3) generators of hazardous matters; (4) transporters of hazardous matters.

Usually, commercial banks will not be identified as the operators and transporters of hazardous matters because of loan behaviors, but to ensure the loans, they will adopt some measures in the practice, for example, they will require lenders to settle the mortgage, send managers to enter into the loan enterprises, participate in lenders' management, even take over the loan enterprise when lenders are in insolvency. In some states of US, mortgagees are the owners of mortgage property in common law, so loan banks will be identified as the owners in CERCLA (House Debate on H.R, 1979). In addition, when mortgagors hand their keys of mortgages to the loan banks, or they give up the mortgages, or loan banks formally take over the mortgage property, loan banks may be identified as owners or managers, becoming the potentially responsible parties.

Loan banks could plead them by the defenses in CERCLA. There are three affirmative defenses to CERCLA liability, i.e. (1) Act of War; (2) Act of God; (3) the Third Party Defense. The most commonly asserted defense is the third party defense. To qualify for this defense, a defendant must establish the following four elements: (1) the release was caused solely by the act or omission of a third party; (2) with whom the defendant had no direct or indirect contractual relationship; (3) that the defendant exercised due care with respect to the hazardous substances ("the due care element"); (4) that the defendant took precautions against the foreseeable acts or omissions of any such third parties ("the precautionary element"). Because the existence of the loan contract between loan banks and the third party, this defense could not be used at most moments in the practice (42 U.S.C. 9607(b)(3)).

2.2 Exemption of guarantee interests

It is the basic and normal commercial act for commercial banks to maintain the securities interests, and if they undertake the environmental tort liability because of that, it will not only be fair to loan banks, but will restrain the loan enthusiasm of loan banks. Therefore, to reduce the fear of loan banks to the environmental legal liability and avoid that loan banks refuse to provide loans, CERCLA prepared the item of safe post for loan banks, i.e. if loan banks have not participated in the management of hazardous matters and facilities, and become the nominal owners of hazardous facilities and vessels, loan banks could not be included in these four potentially responsible parties, which is called as the security interest exemption.

The Asset Conservation, Lender Liability, and Deposit Insurance Protection conducted by the US Congress in 1996 further supplemented the lenders' security interest exemption in CERCLA. When emended this law, some definitions about relative glossaries were added, and the situation that loan banks will not undertake the environmental legal liability for obtaining loan interests was pointed out (42 U.S.C. 9601(20)(E)(i)). So CERCLA secured creditor's exclusion operates to exclude from the definition of "owner or operator" any person who "holds indicia of ownership primarily to protect the security interest" in a vessel or facility and provides that

this person will not be liable as an owner or operator if the person does not “participate in the management” of the facility or vessel. That means in the loan period, when loan banks have not participated in lenders’ affair management, they could exempt them. However, when lenders lose their foreclosure, this exemption will largely reduce the protection to the loan banks.

The regulations about the loan banks environmental legal liability in CERCLA indicate that the premise that commercial banks undertake liability in the environmental tort is that they are identified as owners, operators, generators, and transporters of hazardous matters. But CERCLA didn’t define “owners” and “operators” in detail, so it is very difficult to identify the civil legal liability of commercial banks in justice practice, for example, how to distinguish loan bank is the nominal owner or real owner of mortgage? How to judge loan bank is the operator of mortgage?

2.3 Definition of owners

The legislative history indicated that the purpose of the exemption is to protect lien holders in states where mortgagees are considered to have title to the property subject to the security interest. However, in its CERCLA Lender Liability Rule, the EPA defined the term “indicia of ownership” more broadly so that it applies to all lenders regardless of whether they are located in a “title-theory” or “lien-theory” jurisdiction (both difference mainly is that the ownership parties of mortgage property are different, and in the former situation, the lender is the party of ownership, and only when buyer (borrower) relieves mortgage, the owner is the buyer. But in the latter situation, buyer (lender) always is the owner, and loaner is the lien holder of property). Examples of indicia of ownership set forth in the regulation include mortgages, deeds of trusts, surety bonds, guarantees of obligations, title held pursuant to a lease financing transactions, assignments, pledges, and other forms of encumbrances against property that are held primarily to protect a security interest (Lender Liability Rule, 40 CFR 300.1100(a)).

In most situations, to ensure the security interest, loan banks will become the nominal owner of hazardous matters, and here, it is not fair that loan banks are identified as the owners to undertake the environmental legal liability. The applied standard to distinguish whether loan banks are nominal owners or real owners in the practice is to test the main intention of loan banks, i.e. for the security interest.

The original edition of CERCLA didn’t regulate “for the security interest”. In 1991, EPA made its own explanation about “for the security interest” when it proposed the lenders liability rule of CERCLA, and it thought that “the main intention is to protect the security interest” meant the obligation and liability implemented for the return of loans, which didn’t include the income in the investment of facilities, and owners’ interests obtained except for security interest (56 Fed. Reg. 28802 (June 24, 1991)). Of course, EPA also admitted that loan banks would obtain certain incomes from loans, so if loan banks obtain some incomes and profits from the trading, that don’t mean loan banks will not be protected by the exemption, only if their main intention is to ensure the realization of the security interest (56 Fed. Reg. 28802 (June 24, 1991)). In another word, as the owners, loan banks may have multiple intentions such as withdrawing loans, obtaining profit, convenient for daily control, and if their main intention is to ensure the realization of the guarantee interest, the loan banks will be protected by the exemption.

The CERCLA Lender Liability Rule promulgated in 1992 indicated that the lender’s motivation was irrelevant for purposes of determining whether it “participated in the management of a facility” but was relevant in determining why the lender held its indicia of ownership (57 Fed. Reg. 18354 (April 29, 1992)).

In the loan period, as the nominal owner, the risk that loan bank undertakes the environmental legal liability is relatively small, but when lenders lose the foreclosure because they have not return loans on schedule, and loan banks accept the mortgage property, the risk that loan banks are identified as the owners will increase, and here do loan banks are also been protected by the exemption?

According to the Asset Conservation, Lender Liability, and Deposit Insurance Protection of 1996, only if lenders seek selling the mortgage property at reasonable time by reasonable commercial price and conditions, they will be protected by the exemption (Richard Hooley, 2001, p 405-418). In the added chapter (9607(20)(E)) in the 1996 Lender Liability Amendments also emphasized that under the situation including reasonable time, reasonable commercial price, market status, and legal rules in the commercial practice, financial institutions could cancel lenders’ foreclosure, lease (including sale and lease after sale), or sell mortgages, and didn’t be identified as the owners. This rule didn’t include one specific applied standard, but it required that lenders should make public their property and accept reasonable pricing. If lenders accord with this standard and are identified as the nominal owners, and their main intention is to protect the security interest, they will be protected by the exemption.

But the 1996 Lender Liability Amendments had not define the “mainly protect security interest”, that means in CERCLA, “protect security interest” has not been defined accurately, so the Lenders Liability Rule of EPA (EPA Lender Liability Rule, 57 Fed. Reg. 18382 (April 29, 1992)) had become an execution standard which has been applied in the federal execution. But a court in a private contribution or cost recovery action might find the EPA's interpretation of this term persuasive though the EPA's definition is not statutory and would not be binding on the court.

So, for the judgment of nominal owner, the definition of EPA is the reference of administration execution, but the prejudications of court need to be analyzed in the justice practice.

In the case about UNITED STATES of America; United States Department of Transportation; United States Coast Guard Curtis Bay, Plaintiffs, v. Wilbur McLamb; Barbara McLamb; Investors Management Corporation, Defendants-Appellants. Otto SKIPPER; Jimmy F. Cain; Peggy Cain; Hubert J. Anderson; Ada Anderson, Defendants, v. Wachovia Bank And Trust Company, N.A., Third Party Defendant-Appellee (75 F.3d 69(4th Cir.1993), the court had not made the judge based on the Lenders Liability Rule of EPA which still influenced the court to some extent. In this case, the court pointed out that it independently made the judge even if it depended on the Lenders Liability Rule of EPA. Therefore, when judging whether lenders should undertake liability as the nominal owner, the core issue is to check lenders' motivation of property sign, and only if their motivation is to protect the security interest and they have not participated in the management and control of the loan companies, and even if lenders become the small shareholder of the loan company and cut a melon because of stocks, or become the member of directorate because of the share proportion, they will not lose the protection of exemption (references could be seen in following two cases, Stearns & Foster Bedding Company v. Franklin Holding Company et al; DuFrayne v. FTB Mortgage Services, Inc. See Lawrence P. Chnapf, Lender Liability Today under Environmental Laws, Consumer Finance Law Quarterly Report, spring, 2006, pp. 159-161.).

2.4 Definition of operators

To protect nominal interest, if commercial banks become nominal owner, they will generally obtain the protection of safe harbor, and exempt from the undertaking of liability. However, even if commercial banks have not been identified as the owner, but they may participate in the daily management of loan enterprises or manage the mortgaged property or facilities, they will be identified as the operator.

Different with the blurred definition of “nominal owner” and “protect security interest”, the definition of “participating in management of loan banks” has been increasingly clear through the continual development of the statute law and the case law.

In the original regulations of CERCLA, the situations that loan banks could apply the exemption are blurred and narrow, so the court was stricter to identify loan banks' environmental legal liability in early times. In the case of United States v. Fleet Factors Corporation of 1990 (United States v. Fleet Factors Corp., 901 F.2d 1550 (11th Cir. 1990)), the court thought that the lender should undertake the liability according to CERCLA, because lender's management in the pollution facilities had achieved certain extent, and that had indicated that lender “could” manage and deal with hazardous wastes of the company. So the lender was judged to pay the clearing cost. The original intention of the Fleet Case was to supervise and urge the careful survey of loan banks by expanding the liability scope. But this judgment result induced the fear of loan banks, and they all worried about they would undertake joint liability without fault because of single loans, so banks and financial institutions all would not join the cleaning and reconstruction plan of hazardous fields of the government.

As the response of the Fleet Case, the EPA issued the Lenders Liability Rule in 1992. EPA hoped that the rule could overcome the narrowness of the exemption in CERCLA, and provide a wider explanation. The EPA indicated that the term “participation in management” does not refer to a lender who merely has the capacity to influence the operations of a borrower's facility or vessel or has an unexercised right to control the vessel or facility operations. If the contract between the loan bank and lenders only indicates that the loan bank has the right to take actions for the behaviors that lenders disobey the environment law and leak out hazardous matters, but that doesn't mean the loan bank is the operator (57 Fed. Reg. 18357 (April 29, 1992)). This rule could be applied not only in original lenders, but in succedent lenders and assurers (Gerald L. Blanchard, 1997)).

The Lenders Liability Rule of EPA could provide more protections for loan banks. At the same time, it also listed the behaviors which should not be identified as the “participation in management” (42 U.S.C. 9601(20)(F)), for example, Exercises decision-making control over the borrower's environmental compliance, such that the lender has undertaken responsibility for the borrower's hazardous substance handling or disposal practices; or exercises control at a level comparable to that of a manager of the facility or vessel so that the lender has assumed or manifested responsibility for the overall management of the day-to-day decision-making at the facility with

respect to environmental compliance, or overall or substantially all of the operational functions of the facility or vessel.

To explain the “participation in management” more detailed, the Lenders Liability emendation also added a list which eliminated following behaviors from the “participation in management”, and exempted from legal liability. A lender may take the following nine actions and not be deemed to have participated in management: (1) Holding, releasing, or abandoning a security interest; (2) including environmental compliance covenants, warranties, or other environmental conditions in a security agreement or extension of credit; (3) monitoring or enforcing any terms or conditions of a security agreement or extension of credit; (4) monitoring or undertaking any inspections of the collateral; (5) requiring the borrower to take response actions to address releases of hazardous substances; (6) providing financial or other advice or counseling to mitigate, prevent, or cure default or diminution of the value of the collateral; (7) restructuring, renegotiating, or otherwise agreeing to altering terms and conditions of a security agreement or extension of credit; (8) exercising forbearance of any rights; (9) exercising any remedies that may be available under applicable law for breaches of security agreements or extensions of credit; and conducting a response action under CERCLA in accordance with the National Contingency Plan or under the direction of an on-scene coordinator (42 U.S.C. 9601(20)(F)(iv)).

The emendation of 1996 emphasized that though the Lenders Liability Rule was declared invalidation in the Kelley Case in 1994, it still was effective in the execution scope of EPA. The emendation of 1996 should not be checked by any court. Only the influence would not compose the “participation in management” which required that the loan bank implemented the control right in the practice (Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996, Pub. L. No. 104-208, 2504(a). 110 Stat. 3009-468). And the standard to judge the operator finally fell into place.

3. Countermeasures of Chinese commercial banks to respond the environmental liability risks

At present, in the environment legislation and financial legislation, the environmental legal liability of commercial banks is deficient in China, and in the environmental control, commercial banks could not exert the advantages in capitals, information, and marketization, and effectively control the capital flow of loan enterprises, but as the rational economy entity, commercial banks often invest in many enterprises such as oil and chemical industry with heavy pollution for pursuing high returns, which will further increase the deterioration of the environment.

In the situation of depressed global economy and growth of Chinese economy, Chinese banks buy or share local banks, or establish the strategic fellowship to implement the oversea expansion. Though commercial banks of China have strengthened their capacity to prevent commercial risk through the corporate governance, but many Chinese banks with weak environmental liability risk consciousness still may ignore potential environmental liability, and pay large cleanness charge of the environmental pollution in other countries.

Though loan banks could seek the protection of exemption in the foreign laws, but the narrowness of the exemption will undoubtedly increase the risk, and the strict checking of the court will strengthen the uncertain of the environmental risk. After the lenders liability was emended in 1996, the average charge to clean the pollution field had increased from 12 million dollars before 1996 to 30~50 million dollars (Mark E. Budnitz, 1997). Facing large cleanness charge and the joint liability without fault of CERCLA, Chinese banks which are implementing the internationalization strategy should not treated it lightly, and they should carefully consider various factors in following stages and periods of loan.

3.1 Careful demonstration before providing a loan

Before the loan is confirmed, the loan bank needs review the history of the location of the project, and any risk which may induce the pollution or lender's history such as case record should be checked carefully. At the same time, loan bank should review the possible pollution risk when lender implements the project at this place. Concretely speaking, the risk evaluation of loan bank should be divided into two stages.

The first stage is the analysis of written information provided by the borrower, and if the lender will accept lender's land or asset, this analysis is more important. The checking to the lender should mainly check whether the lender is the defendant because of commercial management, asset use, or disobeying relative regulations in the environment law in the civil or criminal lawsuits. The checking of relative lands and assets should check whether the lands possessed or occupied by borrowers are identified as the polluted lands, and whether the lender received the rectification notice or the charge notice. At same time, other factors should be considered in this stage, such as the former status of this land, the status that the environment law is disobeyed on this land, and whether the lender's property is involved. The information of the register institution including the

rectification notice, the announcement, the bulletin, or the charge notice will help the analysis in this stage.

The second stage is the locale survey. Once potential pollution matters or pollution sources are confirmed, the survey in this stage will begin. In this stage, the professional environment adviser should be engaged to form the written report. To engage professional environment adviser undoubtedly indicates that the loaner has carried careful notice obligation for the land behavior, which will increase the opportunity obtaining the protection of exemption in the future. Before engaging professional adviser, the clear contract with the borrower should be signed first to confirm the engaging party of the adviser, the undertaker of the risk (including the undertaker of the guarantee charge), and the cost executing the survey. The content of the report should include that the intention of the survey is to provide the information for deciding the loan according to loaner's requirement. And the report should explain the checking standard, the checking object, and the instruments. Finally, the results of the tests should be presented clearly, and any assumptions or standards relied upon in order to assess those results should be fully explained (Jonathan H. Marks, 2001).

3.2 Careful prevention of loan contract

The loan contract between the loan bank and the borrower is the main reference that the loan bank undertakes the liability, and to nip in the bud, the loan contract should include following items, (1) the character and scope that the borrower develops and uses this land; (2) the borrower's abidance of the environment law and relative regulations; (3) the borrower's sufficient guarantee for undertaking the environment liability; (4) reporting any proceedings influencing borrower's guarantee.

In addition, in the loan contract, the lender could require that the borrower prepays loans or enhance the loan interest, for example, the borrower disobeys the environment law or relative regulations, or relative lands are identified as the polluted lands or receive the rectification notice. The law allows that the cost signing the contract is undertaken by the lender, but the items about the right of preventing and rescuing the pollution possessed by the loan bank in the loan contract should be avoided as more as possibly, because this appointment is very easy to help the court to think that the loan bank participates in the management of the pollution enterprise, and require the loan bank to undertake the environmental legal liability.

The guarantee contract between the lender and the borrower should also embody above contents in the loan contract.

3.3 Careful management of guarantee assets

If the loan bank requires the borrower to carry out the repayment obligation, which generally doesn't induce the environmental legal liability of the loan bank, but when the loan bank possesses the guarantee property to reduce the loss, for example, the loan bank claims that it has the right for the guarantee property and accepts the guarantee property handed by the borrower, or when the borrower has given up the property, the loan bank will undertake the liability. If the loan bank also participates in the daily management of the borrower, the loan bank will not avoid the environmental legal liability. So, before accepting the guarantee property, the loan bank should consider the further environment survey.

The safer method is to appoint an inceptor of the guarantee property, so the loan bank will not be the mortgagee. The premise to do this is that the method would not influence the inceptor's work, or else, the loan bank still will be identified as the "owner" or the "operator".

The CERCLA has been founded for 20 years, and though the original intention of this law didn't aim at commercial banks, but the joint blameless liability confirmed by it makes commercial banks must emphasize their function in the environment protection, and make them begin to pay attention to the environment liability risk when considering the commercial profit. By the market mode, this law drives the limited financial resources to flow to the industries with environment protection and sustainable development. Once appropriately informed and guided, financial institutions would, through their investment decisions, conditions of financing, and monitoring of companies, become an instrument of environmental governance (B.J. Richardson, 2002), which should be used for references to China.

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