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LENDERS' ENVIRONMENTAL RISK MANAGEMENT: AN UPDATE

The FDIC, Federal Reserve, OCC, and OTS Have Recently Provided Complementary Environmental Risk Management Guidance to Lenders. Under These Guidelines, An Effective Program Should Include Training, Periodic Reassessment of Lending Practices, Pre-Loan Assessment of Collateral, and Protection of Environmental Information.

Cynthia A. Drew and S. Keith Collins*

Another year has come and gone without any Congressional action on Superfund[1] reform. Institutional lenders therefore remain adrift in the uncertainty left in the wake of *Kelley* v. *EPA*,[2] which overturned the United States Environmental Protection Agency's ("EPA's") rule designed to provide a safe harbor against the broadened scope of lender liability envisioned by the Eleventh Circuit in *Fleet Factors*.[3]

Faced with this uncertainty, institutional lenders need assistance in steering clear of their potential environmen-

1. Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA" or "Superfund"), 42 U.S.C. §§ 9601 *et seq.*
2. *Kelley v. EPA*, 15 F.3d 1100 (D.C. Cir. 1994), *cert. denied*, 1995 U.S. LEXIS 535 (U.S. Jan. 17, 1995).
3. *United States v. Fleet Factors Corp.*, 901 F.2d 1550 (11th Cir. 1990), *cert. denied*, 498 U.S. 1046 (1991).

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In January 1995, the EPA announced that it will issue "a guidance" during the next six months stating that it will not seek monetary damages from financial institutions that seize property containing Superfund sites from borrowers defaulting on loans, The new policy will include greater use of "comfort letters," which assure owners that the EPA will not designate properties as Superfund sites. It will also establish loosened criteria for the EPA's use of "prospective purchaser agreements," in which the EPA agrees not to sue the purchaser of a particular site. Noah, Timothy, *EPA Plans Rules to Limit LIability of Superfund Sites*, Wall St. J., Jan. 26, 1995, at A6. At present, it is unclear both what the final form of the proposed EOA "guidance" will be and precisely how much lender liability protection this "guidance," as implemented will ultimately provide.

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tal liabilities. To that end, lenders should consult the guidance documents on environmental risk management issued by the federal regulators of institutional lenders: the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

In this update on environmental risk management, we analyze these guidance documents. If followed wisely, the practical advice that may be gleaned from these documents, which we set forth below, will help lenders retain the benefit of CERCLA's secured creditor exemption. Before addressing these practical pointers, however, it is first necessary to review the changes in the case law that have created the climate of uncertainty now faced by institutional lenders.

LENDER LIABILITY CASE LAW SINCE KELLEY

CERCLA's lender liability exemption excludes from the definition of a liable "owner or operator" 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."[4] The recent problem with interpreting this statutory exemption was caused by the Eleventh Circuit's *Fleet Factors* decision, which created fear and hesitation within the lending community concerning potential liability. In this decision, the Eleventh Circuit ruled that a secured creditor could be held liable under CERCLA without becoming an "operator" if it were sufficiently involved in managing the borrower's affairs that "it could affect hazardous waste disposal decisions if it so chose."[5]

However, the later Ninth Circuit decision, *In re Bergsoe Metal Corp.*,[6] adopted a contrary position to that of the Eleventh Circuit in *Fleet Factors.* In this decision, a more pragmatic one from a lender's point of view, the Ninth Circuit stated that "there must be *some* actual management of the facility" in order to hold a lender liable.[7] Subsequent adoption of the EPA rule[8] further defining CERCLA's safe harbor for lenders gave the Agency's blessing, and additional credence, to the rule of *Bergsoe.* However, the D.C. Circuit has since held the EPA rule to be invalid.[9] Nevertheless, the EPA's comments to its now-overturned rule had explicitly adopted the *Bergsoe* rationale. Thus, the Ninth Circuit's interpretation of CERCLA's secured creditor exemption is the basis upon which the EPA views the issue of lender liability, not that of the Eleventh Circuit in *Fleet Factors.*

It was certainly better from the lending point of view to have had the guidance provided by the EPA rule than to have only the current state of the law regarding lender liability — the absence of direction and confusion prompted by inconsistent case law decisions. However, as the D.C. Circuit concluded in *Kelley*, legislation is a congressional function. The EPA is not empowered to adopt rules that would arguably impinge upon, rather than implement, federal statutes and their enforcement. Abrogation of the EPA rule's attempt to clarify possible additional protection of lenders from environmental liability therefore came as no surprise to the legal community. The EPA rule was only adopted because the appropriate solution, legislative action to clarify the statutory language of CERCLA's secured creditor exemption, was not forthcoming. Thus, lenders are presently left without meaningful EPA or federal statutory guidance beyond the bare bones of the language provided by CERCLA's present lender liability exemption. Lenders must therefore keep abreast of recent trends both in federal case law that interprets and applies the relevant CERCLA provisions, and, where applicable, in state law that interprets and applies analogous state law provisions.

4. 42 U.S.C. § 9601(20)(A).
5. *Fleet Factors*, 901 F.2d at 1558.
6. 910 F.2d 668 (9th Cir. 1990).
7. *Bergsoe*, 910 F.2d at 672 (emphasis in original).
8. National Oil and Hazardous Substances Pollution Contingency Plan; Lender Liability Under CERCLA, 57 Fed. Reg. 18,344 (1992).
9. *Kelley*, 15 F.3d at 1103-04.

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Realistically, only cases that did not rely on the now-invalidated EPA lender liability rule can be considered viable precedents post-*Kelley*. *Northeast Doran, Inc.* v. *Key Bank of Maine*,[10] although decided the month before the EPA rule was overturned, explicitly stated that the rule was "not dispositive in the instant case." In *Northeast Doran*, the First Circuit held that, although the lender taking title failed to disclose its knowledge of hazardous wastes to its buyer, the lender was not liable under CERCLA for the nondisclosure. The basis for the decision was that, as a lender, the seller did not meet the "owner" definition necessary for imposing CERCLA liability for the nondisclosure. It is important to note that this holding was limited to CERCLA issues and that other common law or state law theories of liability might be pursued against a lender under the same or similar facts.

Another recent CERCLA case that did not rely on the EPA rule also involved nondisclosure issues. *Kane v. United States*[11] involved the resale by the Veteran's Administration ("VA") of a house on which it had foreclosed. The sale was "as is." The buyers later discovered that the house contained asbestos and brought an action under CERCLA, claiming the release of hazardous substances and the negligent failure of the VA to inform them of the "true condition of the property." The district court dismissed the CERCLA claim because it found that the house was not a "facility" and that the asbestos was a "consumer product in consumer use," which use did not constitute "disposal" under CERCLA. The Eighth Circuit affirmed the dismissal.

The later case of *Kemp Industries, Inc. and Apollo Associates, Ltd.* v. *Safety Light Corp.*[12] involved an effort to recover against Prudential Insurance Company of America. Prudential took title to an industrial property under a sale-leaseback financing transaction in 1950 and held title until 1964. Prudential was sued under both CERCLA and the New Jersey Spill Compensation and Control Act.[13] In finding that Prudential was not liable as an "owner" or as a participant in management under CERCLA, the district court cited with favor and quoted from the Ninth Circuit's earlier decision in *Bergsoe*:

> "Creditors do not give their money blindly, particularly the large sums of money needed to build industrial facilities.... A secured creditor will always have some input at the planning stages of any large-scale project.... If this were "management," no secured creditor would ever be protected."[14]

Even though the EPA rule itself has now been invalidated, it should be encouraging to lenders that post-*Kelley* decisions such as *Kemp Industries* are relying on *Bergsoe*, the same decision cited by the EPA in its attempt to provide additional protection to lenders by clarifying the "safe harbor" provided for them in CERCLA's secured creditor exemption.

The second argument asserted for Prudential's liability in *Kemp Industries* was the New Jersey Spill Act, a state statute that contains a lender liability exemption. This exemption was enacted as an amendment to the Spill Act in May 1993. Prudential was named as an additional defendant in the *Kemp Industries* suit in August 1992, several months before the exemption was enacted. Nonetheless, the court considered the exemption to be a curative amendment and found in favor of Prudential under the Spill Act's subsequent security interest exemption.

Until Congress acts to clarify CERCLA's secured creditor exemption, lenders can only hope that the rationale of the *Bergsoe* and *Kemp Industries* courts, rather than that of the Eleventh Circuit in *Fleet Factors*, represents the direction in which both federal and state case law develops as courts continue to interpret lender liability exemptions to Superfund-type environmental liabilities.

FEDERAL REGULATORY GUIDANCE

In recent years, all four federal regulators of institutional lenders — the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve, the Office of the Comptroller of the Currency ("OCC"), and the Office of Thrift Supervision ("OTS") — have offered cautionary guidance and recommendations to institutional lenders regarding the need for lenders to practice wise environmental risk management. A review of these documents shows that all four of these regulatory agencies have taken complementary approaches to this issue, although somewhat differing in emphasis. The regulators have, for the most part, issued general documents that do not compel action, leaving considerable room for institutions to design environmental risk-management programs to suit their particular needs. Indeed, the chief value of these guidance documents may well be that they force institutions to take a "hard look" at their own lending practices, which should help motivate the institutions themselves to begin identifying and correcting any deficiencies in these practices.

10. 15 F.3d 1, 3, n.1 (1st Cir. 1994).
11. 15 F.3d 87 (8th Cir. 1994).
12. 857 F. Supp. 373 (DNJ 1994).
13. N.J.S.A. Section 58:10-23.11, et seq. ("Spill Act").
14. *Kemp Industries*, 857 F. Supp. at 395 (quoting *Bergsoe*, 910 F.2d at 672).

The Federal Deposit Insurance Corporation

As discussed in greater detail in an earlier issue,[15] the most recent of these guidance documents, the FDIC Guidelines (the "Guidelines"),[16] specify that an institution should establish procedures for identifying and evaluating "potential environmental concerns associated with lending practices and other actions relating to real property."[17] The Guidelines also specify that the institution's board of directors should review and approve these procedures, and that the board of directors should designate a senior official knowledgeable in environmental matters. This official is to be responsible for implementing the institution's environmental risk program. Finally, the Guidelines specify that the institution should tailor its environmental risk program to its own needs. The Guidelines thus address themselves to two general areas of lending operations: 1) lending procedures, and 2) overall environmental risk management.

An institution setting up an environmental risk program under the Guidelines should (1) provide for staff training; (2) set environmental policy guidelines and procedures; (3) require environmental reviews or analyses during the application process; (4) include loan documentation standards; and (5) establish appropriate environmental risk assessment safeguards in foreclosures and loan workout situations. The Guidelines further discuss the following specific areas to be included in an institution's environmental risk program: training, policies, environmental risk analysis, structured environmental risk assessment, loan documentation, monitoring, involvement in the borrower's operations, and foreclosure.

Two events apparently led to the FDIC's development of the Guidelines. The first was the development of the lender liability case law reviewed above. The second was the FDIC's involvement in thrift failures. As the FDIC became the receiver of failed institutions, environmental risk management concerns "piggybacked" onto the supervision side. The FDIC then developed the Guidelines to offer helpful advice on this topic to the open banks it continued to regulate.[18]

The Guidelines are thus a "red flag," or a "wake-up call,"[19] designed to raise awareness of environmental risk management and practices among regulated institutions. However, the Guidelines are not structured to require financial managers to become environmental experts. The overall tone of the Guidelines is to suggest that one size does not fit all, that an institution's environmental risk management policy should be commensurate with the size of the institution, the nature of the activity, and the kind of exposure that each institution has to environmental risk. The Guidelines certainly permit — and even encourage — financial institutions to leave technical details to environmental experts. Institutions should therefore consult with such experts as needed in order to determine their own compliance. For instance, an institution's staff should not necessarily be assessing the relative magnitude of all environmental risks themselves, especially in complex or questionable circumstances. However, all lending staff need to be trained to know enough about environmental risks to know when to ask for help, or when to call in experts.

If the FDIC finds that an institution has failed to establish or comply with an appropriate environmental risk management program, that deficiency "will be criticized and corrective action required."[20] However, in such a case, the FDIC's complaint about the institution's practices would not ultimately be that the institution violated the Guidelines, but rather that, because of the institution's deficiency with respect to environmental risk management, the institution was not following safe and sound lending practices. Section 304(a) of the FDIC Improvement Act of 1991 requires all banks to have real estate lending policies of (1) an appropriate size and nature, considering their real estate lending practices, (2) consisting of safe and sound practices, and (3) approved annually by the board of directors.[21]

In this context, to take an example regarding loan documentation, it would make sense for an institution at least to put into its own documents the same four kinds of provisions regarding environmental risk that the FDIC itself uses when it sells property: (1) clauses requiring borrowers to comply with environmental laws; (2) clauses requiring borrowers to disclose information regarding environmentally-related matters; (3) clauses providing

15. *Environmental Risk Management Under the New FDIC Guidelines*, Robert L. Graham and Cynthia A. Drew, *The Review of Banking & Financial Services*, Vol. 9, No. 22 (Dec. 22, 1993).
16. Issued on February 25, 1993. In a January 12, 1995 telephone conference, Robert F. Miailovich confirmed that this is the current version of the Guidelines. Robert Miailovich is the Associate Director, Office of Policy, Division of Supervision, FDIC.
17. Guidelines at 2.
18. Remarks of Robert Miailovich at April 12, 1994 Conference *(footnote continued on next column...)*

(footnote continued...)

on Environmental Risk Management in Business and Real Estate Transactions, Washington, D.C.

19. Remarks of Robert Miailovich at November 29, 1993 Conference (reported in Envtl. Due Diligence Guide (BNA), Vol. 2, No. 12, 90 (Dec. 1993)).
20. Guidelines at 5.
21. 12 U.S.C. § 1828(o). See also 12 C.F.R. § 365.2(b)(1).

lenders with the right to acquire information about the borrower's compliance, including rights to inspect the property; and (4) clauses providing lenders with indemnification.

The Federal Reserve

The Federal Reserve has issued a memorandum regarding environmental liability[22] that both provides background information on the subject and recommends environmental policies and procedures for banks to follow. This memorandum states that banking organizations should take steps to avoid or mitigate potential environmental liabilities by (1) preparing environmental policy statements and providing staff training programs; (2) establishing guidelines and procedures for dealing with new borrowers when real property is offered as collateral; (3) conducting appropriate analyses of potential environmental liabilities; (4) reviewing existing loans to identify credits having potential environmental problems; (5) developing recordkeeping procedures to document due diligence efforts made at the time an institution acquires real property or makes loans; and (6) including in loan agreements warranties, representations, and indemnifications designed to protect financial institutions from losses stemming from environmental contamination.

In this regard, safety and soundness are the Federal Reserve's key concerns. However, while appropriate safeguards are "absolutely necessary," the Federal Reserve can draw no "bright line" that identifies precisely which safeguards would in all cases offer an adequate measure of protection from environmental liabilities.[23] Banking organizations must therefore adequately limit their environmental liabilities by adopting protective policies starting with portfolio analysis, and by completing due diligence that varies according to the type of properties involved. Banks must take the initiative to protect themselves in this area because, as noted above, CERCLA itself provides little guidance in interpreting its secured creditor exemption.

22. Issued on October 11, 1991. In a January 12, 1995 telephone conference, Stanley Rediger confirmed that this 1991 guidance is still current. Stanley Rediger is the Supervisory Financial Analyst, Division of Banking Supervision and Regulation, Federal Reserve. The guidance contained in the Federal Reserve Memorandum has since been included in both the Federal Reserve's Commercial Bank Examination Manual and Bank Holding Company Supervision Manual. More recently, this guidance was presented in "Environmental Liability," Fed. Res. Reg. Serv., Vol. 1, No. 3-1520, at 3•552 (1/95).

23. Remarks of Stanley Redinger at April 12, 1994 Conference on Environmental Risk Management in Business and Real Estate Transactions, Washington, D.C.

Within the Federal Reserve system, examiner guidance has two objectives: (1) to determine if a bank's environmental risk safeguards and controls are adequate; and (2) to identify any potential environmental problems with either the bank's portfolio or its non-lending activities. Federal Reserve examiners will therefore look at individual credits to see if banks are complying with these criteria. The Federal Reserve believes that banks should consider periodically reassessing credits with a higher-than-normal risk. It expects lenders to identify high-potential hazards such as gas stations, feedlots, or plating facilities. However, if a bank has a policy that Phase I reports are only required if loans are greater than $250,000 (or $1,000,000, or whatever an institution's "triggering" amount is), the bank would be misinterpreting the Federal Reserve's guidance if the bank considered that Phase I reports were never required when projected loans were less than the "triggering" amount. According to the Federal Reserve, Phase I reports should be considered as an analytical tool whenever there are high-risk indicators of potential environmental liabilities.[24]

Lenders who follow this particular practice will find that it helps them significantly reduce their environmental risks, since the size of the loans made on particular properties may bear very little resemblance to the size of the potential environmental liabilities associated with those properties. In this regard, the most recently published version of the Federal Reserve's guidance regarding environmental liability offers the following representative list of examples demonstrating "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);

- lawn care businesses (application of lawn chemicals); and

24. Remarks of Stanley Rediger at Conference on Environmental Risk Management in Business and Real Estate Transactions, Washington, D.C.

• trucking firms (local and long-haul transporters of hazardous substances such as fuel or chemicals).[25]

The Federal Reserve Memorandum further notes that, although warranties, representations, and indemnifications designed to protect the institution from losses stemming from environmental contamination should be included in loan agreements, such provisions are not binding against the government or third parties. At best, such provisions provide only some measure of protection for lenders. Moreover, lenders should remember that such provisions are only as secure as the borrower's financial strength. Therefore, while it is a good idea to include affirmative covenants in loan agreements and attendant default provisions that require the borrower to comply with all applicable environmental regulations, the Federal Reserve does not consider a bank's including such provisions in its loan agreements as a substitute for completing environmental reviews, assessments, and audits.

In addition to warning that institutions may be held liable for cleanups where they have taken title to property pursuant to foreclosure, the Federal Reserve Memorandum notes other instances where institutions could incur such liability — such as owning or acquiring premises for expansion purposes that had previously been contaminated. Banks should be wary of possible site contamination, for example, at branch office locations where service stations having underground storage tanks once operated.

The Federal Reserve Memorandum also includes more specific cautionary advice than the FDIC Guidelines as to which activities could be considered active participation in managing the borrower's business, and are thus to be avoided. In this regard, the Memorandum recommends that banks avoid having employees 1) serve as members of a borrower's board of directors, 2) actively participate in decisions of a borrower's board, or 3) actively determine changes in a borrower's management. The Memorandum warns that it is especially important for a bank to consider such issues when the bank is actively involved in loan workouts or debt restructuring.

Finally, with respect to its examination criteria, the Federal Reserve Memorandum states that, when reviewing individual credits, examiners should determine that the institution has complied with its lending policies, particularly where the borrower's activities or industries are associated with hazardous substances or environmental liability. In addition, where situations involving potential environmental liabilities arise from an institution's non-lending activities, the Memorandum specifies that examiners should verify that protective policies and procedures are in place. In this regard, the Memorandum offers as an example that a banking organization engaged in trust activities or contemplating a merger and acquisition should evaluate the possibility of what existing or subsequent environmental liability could arise from these activities. This is wise advice. Lenders all too often completely overlook or significantly underestimate such non-lending sources of potential environmental liabilities.

Office of the Comptroller of the Currency

The OCC's Banking Bulletin 92-38[26] regarding environmental liability is a two-page transmittal cover memorandum for the now-invalidated EPA lender liability rule. The OCC had offered the guidance provided by the EPA rule to the institutions it regulates for them to follow as a means to avoid incurring environmental liability. The OCC's philosophy toward environmental risk management is summarized in its statement about the rule:

> "National banks can protect themselves from environmental liability by not participating in the management of properties in which they have a security interest. Each national bank should carefully review the final EPA rule. To avoid environmental liability they should assure themselves that their policies, practices, and procedures are consistent with the definitions contained in the final rule."

When asked about the continuing viability of this OCC guidance to banks after *Kelley*, William Kerr of the OCC Office of Policy stated that the OCC would still tell banks to follow the protective procedures discussed in the EPA rule. He further stated that, if asked, he would also tell them to follow the procedures discussed in the FDIC Guidelines.[27] In addition, Mr. Kerr stated that, in recent speeches he has recommended that banks "know what their environmental risks are in their market areas." In other words, as an item in the OCC's evaluation of a bank's management, the OCC would expect banks to be "looking at" the environmental risks in their market areas

25. Fed. Res. Reg. Serv., Vol. 1, No. 3-1520, at 3•552-3•552.1.

26. Issued in July 1992. A January 13, 1995 telephone conference with William Kerr confirmed that this is the current version of the OCC's policy on environmental liability. William Kerr is National Bank Examiner, Office of Policy at the OCC.

27. April 19, 1994 and January 13, 1995 telephone conferences with William Kerr.

"just" as it would expect them to "look at" the credit risks in their customers.[28]

The Office of Thrift Supervision

The OTS Thrift Bulletin regarding environmental risk and liability[29] is a document remarkable for its specificity, especially since the OTS issued this Bulletin a year before the Eleventh Circuit decided *Fleet Factors*. While giving the same general guidance as the FDIC Guidelines, the OTS Thrift Bulletin includes much more concrete detail in its cautionary advice to the institutions it regulates than do the Guidelines.

Apparently, someone who loved making lists wrote the OTS' four-page policy bulletin. The document begins by giving at least eight basic categories of risk that an institution can face as a result of environmentally-contaminated property. The document next lists five critical purposes of an environmental risk policy, — the last of which is to support the institution's adherence to the principles of safety and soundness. The remaining portions of the document give twelve essential components in an institution's environmental risk policy. These components are further broken down into as many as eleven subparts or, in one case, into four further subdivisions of a single subpart. Those who criticize the FDIC Guidelines as being too vague should be happy to read the much more concrete examples provided by the OTS' Thrift Bulletin as to how financial institutions should act in order to avoid incurring environmental liabilities. The Bulletin also contains a one-page attachment describing Phase I, Phase II, and Phase III environmental risk reports.

Whatever training programs an institution may have already developed for its staff, it may still be helpful for the institution to distribute the OTS Bulletin to its loan officers for use as a supplemental checklist. The Bulletin lists, for example, eleven types of properties for which Phase I environmental risk reports should be conducted. In addition, it gives eight examples (many with further illustrative subdivisions) of criteria for determining the circumstances in which loan requests should be declined due to environmental factors.

The OTS Bulletin further specifies that it should be the loan officer's responsibility to order the Phase I Environmental Risk Report, that the institution should be the client on the report, and that the institution should maintain an approved roster of environmental risk auditors and should use only companies listed on this roster. The OTS Bulletin closes by emphasizing the importance of good internal communication and cooperation, the component that all lending institutions would do well to make the cornerstone of their environmental risk programs:

> "An acknowledgement of the importance of coordination and cooperation among the institution's loan origination department, its loan servicing department, its designated environmental risk analyst, its legal counsel, and its appraisers, to carry out the environmental risk policy and to enlist the help of environmental specialists and applicable government agencies in this endeavor."[30]

PRACTICAL POINTERS

So what kind of road map can lenders ultimately take from the four statements and policies discussed above, which the FDIC, the Federal Reserve, the OCC, and the OTS have promulgated to help the institutions they regulate manage their environmental risks more wisely?

Understand the General Nature of Environmental Liabilities

In general, lenders must better understand the nature of environmental liabilities and must be vigilant in working to minimize them. Lenders should remember that environmental liabilities attach to many borrowers and localities, and that they also attach through corporate affiliations. For example, whether a parent organization is the lending institution or the borrower, lenders should be mindful of the degree to which a parent corporation participates in a subsidiary's activities, particularly in management of the subsidiary's environmental activities.

First, lenders should have a policy to assess environmental risks. As the FDIC Guidelines recommend, lenders should tailor their environmental risk policies to the problems they encounter as lenders, to the specific types of loans that they make, and to the particular credits that are in their portfolios.

Next, lenders should develop training programs that educate their staff about the environmental issues they

28. January 13, 1995 telephone conference with William Kerr.
29. Thrift Bulletin 16, issued February 6, 1989. A January 13, 1995 telephone conference with Therese Monahan confirmed that this is the current version of the OTS's policy on environmental risk and liability. Therese Monahan is Project Manager of Thrift Policy, Office of Thrift Supervision.

30. OTS Thrift Bulletin at 4.

will encounter. In this regard, as noted above, lenders should also ensure that appropriate staff at their institutions also know when to call in the experts. That is, lenders should use the technical expertise of environmental consultants to help in assessing the precise nature of the environmental risks posed by particular properties or activities. Lenders should also have their legal counsel examine their lending practices — in essence, do a compliance audit — in light of the particular lender liability case law that is controlling in relevant jurisdictions. Those presently in the Eleventh Circuit where *Fleet Factors* controls, for instance, have more reason to be cautious in these matters than those in the Ninth Circuit, where *Bergsoe* controls.

Periodically Reassess and Monitor Lending Practices

Lenders should also periodically reassess and monitor their lending practices to see if they are still meeting all appropriate environmental requirements. As lender liability law continues to evolve, actions taken yesterday that were perfectly appropriate may no longer be appropriate, or even desirable, tomorrow. In this regard, lenders should particularly ensure that they are doing enough recordkeeping and documentation of their environmental risk management efforts. For instance, in analogous situations, lenders should at least do the kind of documentation on loans that the FDIC does for troubled properties.

In all such matters, lenders should consider how their situation would appear from other points of view, particularly from a court's point of view. They should then adjust their lending practices, if needed, so that a fact finder would have no alternative but to conclude that the lending practices in question were in accord with the relevant standards of environmental risk management for that type of institution, and for that type of portfolio.

With this perspective in mind, lenders should review their loan agreements — not just the new ones, but also all the old ones on the books. Are there appropriate warranties and indemnifications to protect the institution? If not, when the loan is renewed, or the terms are otherwise modified, appropriate warranties, indemnifications, notification and assessment terms, should be added through a modification agreement. Even if there are such provisions, they may have no value if the borrower has no "deep pockets," or if the borrower becomes liable for a major environmental problem at another site. In this regard, lenders should constantly remind themselves of the necessity adequately to monitor a borrower's other business activities. As noted above, lenders particularly need to examine the non-lending aspects of a borrower's activities. Lenders should be aware that approximately 62 percent of public companies responding to a Price Waterhouse survey conceded that they had not reflected known environmental problems in their financial reports.[31] Lenders should thus avoid exclusive reliance on what the borrower states concerning the extent of its environmental liabilities. In conducting any due diligence efforts regarding environmental risk, lenders should always independently check whatever relevant information is provided by the borrower.

In loan workouts, lenders should also ensure that the measures they are taking are sufficient to avoid participation in management. In this context, lenders should review issues as they arise on a case-by-case basis, and should analyze each issue on its own merits. The "bottom line" is that lenders should do what they need to do, based on the exigencies of their own particular business needs, and should specifically know how and when to revisit the environmental risk issues raised by their present portfolios. Lenders may wish to begin reassessing the environmental risks represented in their portfolios by examining what they perceive to be their large exposures, but they should certainly not stop there.

Today, prudent lenders need to know the operating requirements of all of their borrowers. A loan to a dry cleaner, for instance, while perhaps considered a relatively "small" loan, may represent the possibility of significant environmental liabilities if the site upon which the business operates becomes contaminated. As a matter of policy, lenders should complete Phase I site assessments on all unsecured loans for which complicated issues or questionable situations arise. In short, lenders should develop policies that in all respects truly consider and account for all of a borrower's environmental solvency risks.

Lenders should also implement a policy of monitoring "after the fact" as an essential part of their loan administration. Such monitoring should consist of a periodic reassessment, throughout the life of the loan, of the risks created for the lender by maintaining its present relationship to the borrower. In undertaking such monitoring, lenders must not let their focus be narrowed to see only a specific condition or transaction, but must instead examine the relationship of the borrower's overall activities to the level of environmental risk posed by those activities.

31. *Accounting for Environmental Compliance: Crossroad of GAAP, Engineering, and Government, A Survey of Corporate America's Accounting for Environmental Costs,* Price Waterhouse (1992) at 10-11.

In short, in order to protect themselves from unwanted environmental risks, lenders must continually evaluate the level of environmental risks posed by each borrower/lender relationship.

Conduct Environmental Assessments Whenever Needed to Clarify Specific Environmental Risks

Prudent lenders thus must do more than simply comply with applicable agency guidelines. If lenders look to real property to secure a loan, then a fundamental part of underwriting the loan must always be determining whether that property is environmentally "challenged" or "impaired." Prudent loans simply cannot be made relying upon real property as collateral without appraising and considering the value of that collateral. Arguably, lenders who do not at least conduct Phase I environmental assessments have failed to underwrite the value of their commercial real estate collateral. If a loan is worth the cost of an appraisal, then it is worth the cost of a Phase I environmental assessment. It is only by undertaking this assessment process that lenders gain reasonable assurance that environmental problems will not impair either the value of their collateral or their ability to realize on that collateral by taking title to the property. As noted above, if an institution is only assessing supposedly high-risk commercial properties, the institution may be asking for trouble, both in terms of the quality of the lender's loan portfolio and in terms of its potential environmental liability.

Conducting environmental assessments has unquestionably added to the costs of commercial real estate lending. At times, completing the assessment process has also lengthened the processing time required from loan application to closing. However, lenders should work to streamline this "time line" and to obtain the needed environmental information at a reasonable cost. Many lenders already minimize costs and turnaround time for obtaining environmental audits by structuring master environmental auditing contracts with a few key vendors. As noted above, the OTS Bulletin specifically recommends that lenders adopt such a policy. Identifying high-risk indicators to be used as the basis for doing environmental assessments, a protective measure specifically recommended by the Federal Reserve Memorandum, can also ameliorate some of the problems of costs and expense caused by incorporating the environmental assessment process into the loan approval process.

A borrower in foreclosure does not always cooperate with the lender in obtaining environmental assessments. It is obviously easier to get a borrower's cooperation in such matters before a loan is made, or before a workout that it desires is completed. The environmental liabilities imposed on lending institutions by statutes and case law are also making adversarial environmental assessments and testing easier to obtain as time goes on. However, it is more prudent in the long run for lenders to know the environmental status of the properties upon which they make loans, rather than to try to save money by lending without obtaining environmental assessments before disbursing the loans. In any event, lenders will ordinarily not incur out-of-pocket costs for making such assessments at the inception of the loan or on earlier credits as a part of considering the renewal or modification of the loan. Most institutions require the cost of completing environmental assessments to be borne directly by loan applicants.

While the idea of not requiring environmental assessments for loans under a certain dollar threshold may seem attractive to some lenders, the risk is real that properties with undiscovered environmental problems may weaken lenders' overall loan portfolios if too high a percentage of the portfolios is in loans below that threshold. This could happen once the loans are in trouble and the properties are environmentally assessed in contemplation of foreclosure or in the midst of a borrower's bankruptcy. If lenders do not have appropriate environmental safeguards and procedures in place before that time, some of the "below-the-dollar-threshold" properties may become REO nightmares, costing the lenders many times the amount of the loan. Actual occurrences of those kinds of horror stories were in part what prompted the adoption of agency guidelines for advising lenders how to reduce their environmental risks.

Have a Coherent Policy for Obtaining Environmental Risk Reports on a Confidential Basis

When a loan is already in or is about to become the subject of litigation, lenders should consider whether at that point it is wise to procure environmental information in a manner designed to allow for asserting privilege from disclosure. One recent case held that the appropriate actions had been taken to safeguard an environmental audit from disclosure under the attorney-client privilege. The court denied a motion to compel disclosure of audit information in discovery.[32] There are differing philosophies as to whether lenders should seek to protect confidentiality and privilege claims. For example, in a bankruptcy where environmental information might impact valuation

32. *Olen Properties Corp. v. Sheldanl, Inc.*, No. CV 91-6446-WDK (Mcx), 1994 U.S. Dist. LEXIS 7125 (CD Cal. April 12, 1994).

issues, maintaining the benefit of such a privilege of confidentiality could prove to be important. However, to establish this privilege, careful procedures must be followed, beginning even before the report is ordered. Maintaining such a privilege of confidentiality can therefore best be effectuated if procedures to seek to do so are already set forth as part of a lender's well-planned environmental risk management policy.

For lenders to structure their environmental consulting agreements in a manner designed to protect the privilege of confidentiality necessarily involves counsel not just in the design of the safeguards, but also in the process surrounding the ordering, receipt, distribution, and restriction of access to environmental reports. For example, in nationwide commercial real estate lending, ITT Real Estate Services ("ITT") has found it best to pursue a case-by-case approach to confidentiality and privilege. Although adopting this approach provides less of a "bright-line" test than would seeking to protect or not to protect all environmental reports, it is pragmatic and functional. In adopting such an approach, ITT has chosen to protect the confidentiality of such reports only when there is a genuine sensitivity to the information they contain. Adopting such a selective, as opposed to a "shotgun," approach may lend more credibility to ITT's assertion of privilege and confidentiality when the issue is challenged. It also eliminates some otherwise unnecessary involvement of counsel in reports on new loan applications and on other less sensitive matters.

ITT's Master Environmental And/Or Engineering Consulting Agreement includes a section designed to give the lender flexibility in deciding when to safeguard a claim of privilege.[33] That section also spells out the procedure that will be followed to protect confidentiality. Including such a section in their own environmental consulting agreements may help lenders successfully overcome the stumbling block frequently encountered when outside litigation counsel are hesitant to become actively involved in contracting for the audit work, or otherwise to become embroiled in negotiating a contract with the consultant. Pursuant to its consulting agreement, ITT's attorney orders the report in the name of the client ITT, for the benefit of the client ITT. The contract provides that reports are, except as otherwise provided, not for the benefit of third-party beneficiaries.

Thus, when there is a concern regarding work-product, privilege, or confidentiality, the environmental consulting report is ordered by ITT's counsel and directed to ITT's counsel. Otherwise, the report is ordered, received, and initially reviewed by non-attorneys in ITT's Environmental Policy Department. Although there is obviously no guarantee that this or any other system designed to protect confidentiality will succeed in all cases, adopting such a policy will help satisfy lenders' business needs while decreasing the odds of lenders

33. The text of Section 22 of ITT's Master Environmental And/Or Engineering Consulting Agreement sets forth the following procedures to be followed in order to seek to protect the confidentiality of environmental consulting reports:

> 22. **PRIVILEGE AND CONFIDENTIALITY** Except when there is a duty to promptly report or give notice to a governmental or regulatory entity, or to the owner or operator of the Project, of results of a test or conditions at the Project (in which case Consultant shall immediately provide ITT with a copy of any such disclosure and a written explanation of the reasons for such disclosure), Consultant will not publish or make known to third parties, results or information obtained from Consultant's performance of Services under this Agreement without in each instance the prior written approval of ITT. All information obtained by Consultant under this Agreement shall be made available to ITT pursuant to this Agreement. Consultant shall communicate promptly and without request to ITT

(footnote continued on next column...)

(footnote continued...)

> all information that Consultant deems pertinent to their respective interests.
>
> Except to the extent a duty to promptly report or give notice exists, as provided for above, when a Notice to Proceed is issued by either ITT's in-house attorney or ITT's outside counsel indicating that the Services are to be treated as privileged and/or confidential, Consultant shall direct the requested report and all related oral and written communications only to the attorney, or as directed by the attorney. All reports and related documentation prepared by Consultant for such Projects shall be marked "LEGAL AND CONFIDENTIAL COMMUNICATION." Those reports and all related documentation shall be maintained by Consultant in locked filing systems. Access to all such reports and related information shall be limited by Consultant on a need to know basis to those involved in providing the Services for that Project. For all such Projects, the Consultant shall maintain the confidentiality of the reports and all related information, consistent with protection of any and all applicable confidentiality privileges and doctrines, including but not limited to attorney-client privilege, self-evaluation privilege and attorney work-product doctrine. Where so directed in the Notice to Proceed, such reports shall be addressed to both the attorney and ITT. However, the documentation and information shall only be distributed and communicated by Consultant as directed by the attorney.

being compelled to disclose a report or its contents. To some extent, such issues should always be considered and the decision made as to whether to seek to protect the confidentiality of particular information on a case-by-case basis. Sometimes, even where the privilege could be asserted, the lender may elect instead to disclose the results of an audit for other business reasons.

The "bottom-line" approach to such issues from a lending perspective should be to realize that policies, procedures, or contracts that may work well for one lender or situation may not work at all for another. Flexibility and adaptation to lenders' different market areas, business structures, and needs are critical factors not only at the stage where lenders' policies and procedures are initially developed and implemented, but also on an ongoing basis. It is important for lenders to recognize that, if contract, procedural, or policy changes are needed to conform lending practices to current standards of wise environmental risk management, lenders should take steps to effectuate such changes before adherence to or the efficacy of existing policy simply breaks down. Just as the scope of environmental audit issues and services routinely reviewed and ordered by lenders has changed with the continued evolution of lenders' environmental awareness and their growing realization of the importance of wise environmental risk management, environmentally sophisticated lenders will continue to change their approaches and procedures further to limit their environmental risks as new information provides additional means for them to do so.

CONCLUSION

Prudent lenders who wish to make good loans while avoiding environmental liabilities must develop programs in keeping with both applicable agency guidelines and wise environmental risk management. Such programs must encompass lending practices throughout the life of each loan — beginning with loan origination and underwriting, continuing through any workouts and loan modifications, to foreclosure, ownership, and remarketing of the asset. For such programs to be successful, lenders must educate their staff in each of their affected areas of business operations, and maintain ongoing environmental vigilance of their staff's activities relating to both the loans made and the collateral offered for those loans.

Applicable agency guidelines are best used simply as a starting point from which lenders should develop their own environmental programs. Such programs should work in a manner that prudently balances environmental risks with the other costs of doing business and that, whenever possible, finds creative ways to serve the needs of both without compromising either. Lenders should in fact find that developing more comprehensive environmental risk management programs will enhance the efficiency and effectiveness of their present lending practices. As evidenced by the guidance provided by the regulators, lenders who have already implemented well-planned environmental risk management programs can expect that these programs will pay continued economic dividends both in avoiding future liability and preserving the value of their portfolios. ■

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