ENVIRONMENTAL LAW AND REGULATION - Potential Impact on Financial Transactions

The Impact of Environmental Law and Regulations on Financial Transactions: Emerging Issues Drawn From the North American Paradigm

DANIEL L RABINOWITZ

Shearman & Sterling
Attorneys, New York

I THREE WAVES OF UNITED STATES ENVIRONMENTAL LAW

A. Focus on emissions control (early 1970s)

1. Clean Air Act, 42 USC 7401 ***et seq*** (1970)

2. Clean Water Act, 33 USC 1251 ***et seq*** (1972)

3. Ignores historical pollution

4. After initial resistance, consensus now exists that emissions control is appropriate focus for pollution control

5. Capital expenditures for emissions control technology now in place

B. Allocation of liability for 150 years of industrial pollution (early 1980s)

1. CERCLA, 42 USC 9601 ***et seq*** (1980)

   a) Strict, joint and several, retroactive liability for owners and operators

   b) Definition of "owner or operator" broadly drafted and broadly interpreted by federal courts

   c) No equitable defence to liability, although adjustment within private sector provided for

   d) Economic rationale of this liability allocation system still not established

2. Estimate of total cleanup costs for known inactive hazardous waste sites: $125-800 billion

C. Return to emissions control (early 1990s)

1. Clean Air Act Amendments (1990)

a) Emphasis on non-attainment areas, alternative fuels, toxic air emissions, acid rain (sulphur dioxide and nitrous oxide emissions), permits, enforcement, and the "greenhouse effect" (global warming due to gaseous emissions)

2. New Stormwater Regulations (December 1990)

a) Require permitting and control of emissions of stormwater from large industrial plants and publicly owned treatment works

3. Upcoming reauthorisation of federal Clean Water Act and Resource Conservation and Recovery Act ("RCRA")

4. Additional forthcoming issues relating to greenhouse gas and ozone depletion concerns

D. Issues at hand for lenders are: (i) appropriate credit underwriting, and (ii) avoidance of direct liability for contamination

E. The paradigmatic transaction: a loan to an operating business

1. Valuation is the first concern

a) The operation of the borrower's business

(1) Can the business be lawfully operated to continue generating the revenues reflected in the historical financial information?

(a) Are necessary permits in place?

(b) Can the business comply with their terms and limitations?

(i) Are problems industry-wide or facility-specific?

(ii) Do problems relate to raw materials shipment, storage or handling? To waste streams? To process technology? To product formulation?

(c) What is the relationship to the regulatory agencies?

(d) What are the significant constraints on operations imposed by compliance with permit terms?

(e) What are the production or other facilities like, and where are they located?

(i) What are the known or likely pathways and receptors for spills and emissions?

(ii) What are the local or regional political sensitivities?

(f) Hazardous operations and/or materials?

(i) Is there proper safety management?

(ii) Hazard warning and/or emergency planning?

(iii) Will SARA III compel disclosures that would embarrass or cause problems for an acquiring entity?

(g) Are source reduction and waster reduction agenda items for the facility?

(2) If changes in the operation of the business are contemplated in the projections, are the proposed changes reasonable in light of the environmental operating constraints?

(a) Are permit loading conditions, on and off-site (eg, POTW capacities, sewer line diameters, etc) sufficiently elastic to permit augmented waste streams or emissions?

(b) Is there sufficient space, water, power, etc, to allow for additional control equipment on-site?

(c) Do materials handling, storage, transshipment, and other environmental and safety norms permit increased production activity?

(3) Is the environmental capital budgeting process reliable, and are the capital requirements for such expenditures fairly portrayed?

(a) In assessing the financial statements, have expenditures for environmental controls been timely made, or have they been deferred or ignored?

(b) Does the business have a mechanism for planning and adding such expenditures to its capital appropriation process?

(c) What capital assumptions about such expenditures underlie the projections?

(4) What are the future regulatory trends that can reasonably be anticipated in the areas or industries in which the business operates?

(5) What kind of attention from management do environmental issues receive?

(a) Who is in charge of such issues? Is compliance centralised at corporate staff levels, or is it left to individual facilities?

(b) To whom do the environmental engineers report?

(c) Is the company in compliance?

(d) Is the business able to respond to regulatory change?

(e) Is the business actively managing environmental issues, or is it simply responding to issued regulations?

(f) Does senior management care?

b) The burden of the past

(1) On-site conditions - owned and leased sites

(a) Are environmental conditions at the sites used by the business well understood and documented?

(i) Is documentation available about past site history and use?

(ii) Has the site been studied and/or tested?

(iii) Is the hydrogeology understood?

(iv) Are regional water (surface and ground) conditions understood?

(v) Structural issues - heating, asbestos, urea formaldehyde, etc

(b) Is site remediation required at present?

(i) What regulatory initiatives are involved?

(ii) Is the work proceeding or planned to proceed by approved plan? What are the standards and remediation technologies involved?

(c) What will drive future remediation programs, and when? What is the likely expenditure profile?

(i) Regulatory initiatives likely?

(ii) Cost sensitivities-impact of land ban; changes in remedial technologies ***in situ*** versus excavation and off-site disposal

(iii) Likelihood of migration of contamination

- timing issues
- downstream sensitivities
- potable/process water issues
- deferral versus proactive management of labile contaminants - appropriate contractual allocation of responsibility, association of expenditure with revenue
- other PRP guests at the party?

(d) Real estate valuation and management issues

(i) Potential deed restrictions and/or transfer restrictions; superlien statutes

(ii) Changes of use issues - financial surety, remediation programs, etc

(iii) Current valuation assumptions about real property embodied in the transaction - use as collateral, early disposition or divestiture

(e) Past ownership, operation or lease of sites

(i) Contractual issues - allocation of liabilities, indemnities, insurance issues

(2) Exposure from past instances of non-compliance

(a) Regulatory penalties, enforcement orders, etc

(b) Citizens suits (State and Federal Laws)

(3) General environmental contingent liabilities

(a) Contractual liabilities to third parties

(b) TSCA-OSHA third party/worker/ exposure issues

(c) Neighbours

(i) Property damage

(ii) PI claims

(iii) Political/public relations issues

(4) Insurance coverage issues

(5) Structural considerations

(a) parent/subsidiary liability under CERCLA and state laws

(b) shareholder liability issues

F. The transaction as solvent: not all financings are created equal

1. ECRA-type statutes: CT, NJ, IA, IL; under active consideration in NY, DEL, CAL

a) required notices, interaction with regulators

b) site characterisation and/or remediation expenses

c) financial assurances

(1) fixing amounts

(2) integration with transaction financing

d) important issues of control, authority and responsibility; sensitive issues of timing

2. Permit transfer issues

a) transactional form may not end inquiry

b) financial assurances

c) RCRA Permit transfers - trigger for connective action regulations

G. The nature of the due diligence process - environmental epistemology

1. Shift of focus from waste streams, structures and zoning to subsurface conditions

a) the regulatory conundrum - analytical sensitivity, epidemiological ignorance

b) the nature of the site characterisation process - probabilistic analysis

c) importance of past history and present hydrogeological setting

2. Covert data collection

a) Public issues: 10-K, 10-Q

(1) Reg S-K; the MD & A discussion; capex; earning; competitive position - disclosure criteria; recent SEC interpretive release

(2) FASB 5-nature of contingent liabilities

b) EPA databases

(1) CERCLIS

(2) RCRA 3010, Part A applications

(3) CERCLA 103 notices

(4) Summary violation reports

(5) CWA 304(1) filings

c) Public records, clippings searches, etc

3. Overt data collection

a) Contact with regulators

b) Contact with target/partner

c) Files, audit responses; standardised document request

4. The accounting/disclosure conundrum

a) The difficulty of developing a common language

b) The ***Pearse*** Report

c) Unites States SEC initiatives

d) EC Eco-Audit proposals

e) CERES Institute

f) Holistic view not yet in sight

5. Fundamental issues: information triage

a) Use of engineering consultant

b) Time and exposure

c) Target sensitivities

d) Confidentiality

II **CREDIT PROCEDURES AT LOAN ORIGINATION**

A. Environmental due diligence investigation prior to commitment letter

1. Helps evaluate credit worthiness of borrower and value of collateral

2. May provide basis for "innocent purchaser" defence

B. Discovery of non-compliance

1. Compliance should be condition of loan

C. Discovery of contamination

1. Consider not taking security interest in the property

2. Cleanup should be condition of loan if required under state law

D. Environmental representations, warranties, covenants, indemnities and guarantees

1. Lender role as environmental policeman cannot be avoided; advantage of benefits provided by these terms should not be lost

2. Given the developments at EPA and in Congress, it is premature to undertake wholesale changes in policy regarding loan documents or practices

III **ENVIRONMENTAL COSTS AND LIABILITIES AFFECTING BORROWERS' BUSINESSES**

A. Remedial obligations under CERCLA and analogous state statutes

B. Compliance requirements under other federal and state environmental statutes

C. Civil penalties, damages, judgments and liens, including state superliens

D. Potential criminal liability

E. Drafting issues

1. Importance of defining environmental issues at earliest paper exchange - offering memorandum, bid letter, draft letter of intent. Helpful to place discussion of issue in valuation process where it belongs

2. Some typical representations and warranties

a) presence of all required permits, expirations, etc

b) compliance with their terms

c) general statutory compliance

d) existence of proceedings, suits

e) condition of properties

f) other obligations

g) schedules

h) issues of materiality, knowledge, survival

3. Some typical closing conditions

a) due diligence, access, etc

b) permit transfers

c) regulatory compliance

(1) notice

(2) ECRA

(3) financial assurance

4. Indemnity issues

a) snapshot approach - "arising out of"

b) phase-in or split

c) caps

d) timing - risk of regulatory change, land use change, etc

e) security

f) operational control versus financial responsibility

5. Regulation of future conduct of sites - issue for seller as well as buyer

IV LENDER LIABILITY UNDER CERCLA

A. As presently enforced, the statute can require lender with security interest in contaminated property to either: (i) relinquish right to foreclosure or (ii) assume cost of cleanup if borrower is unable to pay

1. Lender may be caught in CERCLA's strict, joint and several and retroactive liability scheme if it exercises foreclosure right or participates to unacceptable degree in management of borrower. Anomaly that CERCLA protects the security interest but does not allow it to be used

B. Congress appears to have believed that lender liability is necessary to effectuate the statute's purpose (ie, maximising the private sector's share of CERCLA costs)

C. Lender liability under CERCLA is a statutory artifact in opposition to common law notions of creditor/debtor relationship

D. Detrimental consequences of imposing lender liability under CERCLA

1. Restricted availability of credit for chemical and chemical related industries

a) Prohibitively expensive environmental audit for small loans; and

b) Lack of available insurance

2. Value of security interest disappears with negative consequences of foreclosure

3. Increased cases of S&L bailout as RTC is further burdened with CERCLA liability from insolvent S&Ls

V STRUCTURE OF CERCLA

A. Four classes of parties liable under CERCLA

B. Definition of "owner or operator" provides so-called "secured creditor exemption": "***... Such term does not include a person, who, without participating in the management of a ... facility, holds indicia of ownership primarily to protect his security interest in the ... facility.***" 42 USC 9601(20)(A)

1. Loss of secured creditor exemption by either of:

a) Participation in management of borrower's operations in absence of foreclosure, or

b) Ownership through foreclosure

2. Unclear guidance from CERCLA's legislative history (1980 US Code Cong & Admin News 6160) regarding what constitutes "participation in management"

3. Congress amended CERCLA in 1986 (the Superfund Amendments and Reauthorization Act ("SARA")), adding a specific exclusion for state and local governments that take title to property through foreclosure; no similar exclusion for commercial lenders

VI FEDERAL COURTS' LACK OF CONSISTENCY IN THEIR DELINEATION OF "PARTICIPATION IN MANAGEMENT"

A. ***Unites States v Mirabile***, 15 Envtl L Rep (Envtl L Inst) 20,994 (ED Pa Sept 4, 1985)

1. The participation that is critical is participation in "operational, production or waste disposal activities"

2. "Mere financial ability to control" is not sufficient for the imposition of liability

B. ***In re Corona Plastics, Inc***, 99 Bankr 231 (Bankr DNJ 1989)

1. Landlord claim that secured creditor of tenant was "owner and operator" of site for purposes of New Jersey ECRA statute; claim rejected by court upon showing that lender not "involved in actual business operations"

C. ***United States v Nicolet, Inc***, Civ No 85-3060 (ED Pa May 10, 1989)

1. Applied ***Mirabile*** standard

D. ***United States v Fleet Factors Corp***, 901 F2d 1550 (11th Cir 1990), ***cert denied***, 111 S Ct 752 (1991)

1. In winding-down of corporate affairs, lender held to have participated in borrower's management even in the absence of foreclosure

2. Liability attaches if:

a) Secured creditor participates in the "financial management" of a facility to a degree indicating a capacity to influence the corporation's treatment of hazardous wastes, or

b) Secured creditor's "involvement with the management of a facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose"

E. ***In re Bergsoe Metals Corp***, 910 F2d 668 (9th Cir 1990)

1. Plaintiffs alleged that "participation in management" test was satisfied by showing the power to manage

2. Court (without addressing financial management, an issue not before it) held that some actual management was necessary to constitute "participation"

F. Cases clearly indicate the USEPA and third parties are aggressively exploring the parameters of "participation in management" AND that the federal courts have not yet conceived a convincing rationale to limit those parameters

VII FEDERAL COURTS' ASSESSMENT OF CERCLA IMPLICATIONS OF OWNERSHIP FOLLOWING FORECLOSURE

A. ***United States v Mirabile, supra***

1. Foreclosure after operations had ceased, followed by securing property against vandalism and resale within four months, held entitled to exemption

B. ***United States v Maryland Bank & Trust Co***, 632 F Supp 573 (D Md 1986)

1. Ownership for four years following foreclosure, and including ownership at time of cleanup, held to preclude applicability of the exemption

C. ***Polger v Republic National Bank***, 709 F Supp 204 (D Colo 1989)

1. When lender to tenant foreclosed on personal property at a site, the owner brought a CERCLA claim against bank claiming "owner or operator" status; court allowed claim to proceed

D. ***Guidice v BFG Electroplating & Manufacturing***, 732 F Supp 556 (WD Pa 1989)

1. Taking title through foreclosure, even if only to facilitate sale to third party, precludes protection under secured creditor exemption

2. Fact that bank held title for only 8 months did not matter to court's analysis

E. Trends show that courts are essentially unwilling to apply secured creditor exemption to include foreclosure pursuant to existing security interest

VIII EPA DRAFT RULE PROVIDING "SAFE HARBOUR"

A. In major policy reversal, EPA has issued draft proposed rule that would limit lender liability under CERCLA more than federal courts have allowed

B. Proposed rule rejects ***Fleet Factors*** standard

1. Only the ***actual*** exercise of "***operational*** management control" by the lender will constitute "participation in management" of a facility (although lender must not cause or contribute to environmental harm)

2. Lenders may require cleanup of a facility prior to or during the life of a loan; require assurances of compliance with environmental laws; monitor or inspect both the facility itself and the borrower's business or financial condition; provide periodic financial or other advice; take other action necessary to police a loan; and undertake "loan workout" activities, such as restructuring, renegotiating, foreclosing, liquidating, or otherwise acting to recover the value of the security interest in a manner consistent with good commercial practice and environmental protection. None of these activities is evidence of "participation in management" that would void the secured creditor exemption

C. Acquiring title through foreclosure does not preclude availability of the exemption

1. Lender must act to preserve the assets for subsequent sale at the earliest possible time, with a presumption in the lender's favour if property is sold within six (6) months; and

2. There is no presumption against a lender if property is held for longer than six months. The lender must show that it continues to hold the property primarily to protect its security interest, taking all relevant facts and circumstances into account

D. Pre-loan due diligence investigation is not a prerequisite for the secured creditor exemption, but it does evidence that a lender's activities are consistent with the exemption

E. Government must be reimbursed for lender enrichment due to EPA cleanup of property

IX LEGISLATIVE PROPOSALS TO CLARIFY SECURED CREDITOR EXEMPTION

A. Garn (R-Ut) s651: amends Federal Deposit Insurance Act

1. Limitation of CERCLA liability of:

a) Government regulatory agencies (eg, FDIC and RTC) when performing ordinary tasks of lending and foreclosure

b) Mortgage lenders with respect to (i) property acquired through foreclosure and (ii) property subject to financial control or oversight pursuant to the terms of an extension of credit

c) Insured depository institutions with respect to (i) and (ii) above plus (iii) property managed in fiduciary capacity

2. Liability is limited to the actual benefit to the institution by a response action undertaken by another party

3. Affirmative duty of regulatory bodies to develop procedures to encourage industry's avoidance of environment risk

B. LaFalce (D-NY) HR 1450: amends CERCLA secured creditor exemption

1. Exemption available to:

a) Lending institutions that acquire property through foreclosure pursuant to a security interest

b) Institutions owning land in a fiduciary capacity on behalf of a third party

c) Indenture trustees with respect to property acquired on default of a debt instrument; and

d) Lending institutions acquiring ownership pursuant to lease arrangements

2. Largely tracks proposed EPA rule

C. The complex political environment - environmentalists; lenders; industrial entities; the Administration and EPA; the RTC sensitivities; legislative action possible but uncertain

X "INNOCENT PURCHASER DEFENCE" NOT ORDINARILY AVAILABLE TO SECURED CREDITOR

A. The defence requires that, by a preponderance of the evidence, the party asserting the defence prove that it:

1. Purchased without notice of contamination

2. Made adequate investigation prior to purchase; and

3. Exercised due care to prevent exacerbation of contamination

42 USC 9607(b)(3)

B. Innocent purchaser defence almost never available to commercial lenders since investigation and diligence by lenders are industry standard

C. An amendment to CERCLA, setting out certain "safe harbour" due diligence efforts that create a presumption of entitlement to "innocent purchaser defence," proposed in 1990 (Weldon (R-Pa) HR 2787)

1. Establishes rebuttable presumption of adequate diligence and of availability of innocent landowner defence

2. To establish the defence, the lender must conduct:

a) Historical research into uses of property

b) Research into governmental records with respect to property (eg, EPA hazardous site lists); and

c) Site inspection by environmental professional for obvious signs of contamination

XI THE NEW FRONTIER: AIDING AND ABETTING REGULATORY VIOLATIONS

A. ***O'Neil v QLCRI Inc***, 750 F Supp 551 (DRI 1990)

1. Mortgagee potentially liable for Federal Water Pollution Control Act violations because it knew of a sewage problem on the property and could have conditioned loans on fixing it

2. Significance of holding obscured by evidence of collusive banking practices

XII LOAN WORKOUTS

A. Protection through guarantees

1. Repayment guarantee allows lender to avoid workout or foreclosure

2. Indemnification guarantee allows lender to participate in workout with comfort

B. Participating in management

1. Merely having the power to get involved in management is not enough; creditor must, as a threshold matter, exercise actual management authority (***Bergsoe***)

2. Creditor cannot be held liable for failing to exercise rights to affect hazardous waste disposal decisions if it has not exercised any rights at all

3. Before proceeding actively in workout creditor should weigh the amount of the loan against potential costs of compliance or clean-up

a) Requires that environmental assessment be updated

C. Viability of foreclosure

D. Impact of bankruptcy

1. ***United States v Union Scrap Iron & Metal***, 1990 US Dist LEXIS 18208 (D Minn Dec 1990): For bankruptcy purposes a claim arises when cleanup costs are expended - not upon the release of hazardous substances. NB: EPA did not know that bankrupt was PRP at time of reorganisation. ***Contra: In re Chataugay Corp***, 112 BR 513 (Bankr SDNY 1990) (currently on appeal)

2. ***Union Scrap*** decision drastically extends period of uncertainty for lenders. Need to be concerned about participation in workout and reorganisation process

XIII BANK POLICIES AND IMPLEMENTATION

A. Written policies for loan officers' use

B. Technical and legal experts

XIV CONCLUSION

A. The precise contours of the CERCLA direct liability debate in the United States are unlikely to be replicated elsewhere

B. But broader structural issues will nevertheless place the lender in a new and deepened relationship to the borrower's environmental problems in all systems

C. A solution to the accounting and disclosure issues will materially facilitate progress

D. The holistic view is essential

ORAL PRESENTATION OF PAPER BY DANIEL L RABINOWITZ

In April 1991, for the first time in its history, Moody's Investor Rating Services published a special comment on environmental issues. It is the first such comment ever made by a rating agency. Neither Moody's nor Standard and Poors have thus far had occasion to deal with environmental issues directly, but Moody's felt impelled to comment across the board about the credit rating of corporate bonds traded in the United States and international capital markets and Moody's put the issue for its readers as follows.

It suggested that some industries may bear such substantial costs for environmental compliance and environmental remediation that the credit profile of those industries may in fact be substantially altered. These industries include chemicals, petroleum refining, marketing, storage and distribution, metals, mining, electrical equipment, electronics manufacturing, plastics, rubber products, pharmaceuticals, waste management, pulp paper, agribusiness and heavy manufacturing.

That is a landmark report on Moody's part. What I would like to discuss with you today, are some of the reasons which led Moody's to issue this report, some of the ways in which US environmental law has developed, and some of the lessons that I think may profitably be drawn from these developments for the international credit market and for the conduct of financing transactions in general.

I would like to begin by talking a little bit about the development of American environmental law. Not, I hasten to add, because I hold it out as a model which ought to be slavishly followed or even emulated at all in other parts of the world, because we have made more than our share, I think, of regulatory and conceptual mistakes in the way we have approached environmental regulation in the United States; but because a consideration of the way in which US laws have dealt with these issues will be instructive as to the fundamental, underlying, structural issues with which all of the developed societies will eventually have to come to deal with and which will in turn have a significant impact on the way in which financing transactions are conducted.

In the United States, environmental law has fundamentally proceeded in three major conceptual waves. Each of them has its own distinct characteristics, each of them was associated with a particular time and place, each of them advert to different areas of significance for the lender and for the borrower, and for the investor in the international credit markets - in the secondary markets.

The first of these waves was actually not the first. Originally American environmental law began around the turn of the century with the impulse towards conservation of wildlife resources embodied in the Roosevelt administration. But thereafter a lengthy hiatus ensued. The first of the waves came in the late 1960s and the early 1970s with the enactment of the national Environmental Policy Act followed in quick succession by the Clean Air Act and the Clean Water Act. It is worth stopping for a minute to consider the conceptual premises which underlay these statutory enactments.

The idea behind these statutes was that the way to remediate what was viewed then and continues to be viewed as a potentially deteriorated environment was to regulate future emissions. Both the Clean Air Act and the Clean Water Act share the same administrative structure, each of them sets up a system nation-wide of permitting and enforcement which allows the regulation of emissions in the case of the Clean Air Act from factory smoke stacks and from other sources of emissions. Neither of these statutes, I should note, is directed in particular at heavy industry. Both of them have much broader application and we will return to that shortly. The Clean Water Act in turn was designed to regulate the emission of contaminants to surface waters, to ground waters, through factories or other kinds of effluent systems of a liquid nature.

The idea was that we would be able to help the environment by setting up a permitting system which would enable regulatory authorities to begin the process of ratcheting down emissions over time. Those who emitted would be required to obtain permits, the permits would contain conditions and parameters which may not be exceeded except upon pain of law, and in due course a substantial tightening of the standards for such emission would eventually be put into place.

For the next ten years really, from 1970 to 1980, the environmental regulatory debate in the United States centred around what was at first the relatively implacable opposition of the major manufacturing industries to this new species of government regulations and what was an increasingly stringent, if perhaps untutored, government response with a kind of an uneasy political balance ultimately being struck between the regulated community and the business community on the one hand, the administrative agency on the other, and Congress with an over-arching supervisory role directly responsive to what became increasing public pressure for greater stringency.

What is worth noting however, about this regulatory structure, and about this first wave of American environmental law, is the fact that it is solely a future oriented species of regulation. The idea is to control what is emitted next week. The idea is to minimise, if possible, what will be emitted the month after that. To be sure it sets up retroactive penalties and a system of enforcement in order to maintain its standards, but fundamentally this is a forward-looking regulatory scheme. It was left to the second great wave in American environmental law to deal with the second problem in environmental law, the second structural issue which each of the developed societies needs to deal with.

That issue is the question of, even assuming we have put into place a system which effectively regulates, monitors, and diminishes those emissions, what we should be able "to put" into the environment next week and next month, from our sources of contamination. What are we going to do about the contamination which is already extent in the environment, distributed throughout our environment as the residue of 150 years, in our case, of intensive industrial and intensive agricultural activity? Neither the Clean Air Act nor the Clean Water Act, nor any indeed of the statutes which accompanied them in this first wave of American environmental law, even purported to address this problem. It is not entirely clear that the Congress recognised at the time how fundamental the dichotomy was between the question of future oriented emissions regulation on the one hand and the distribution of costs attendant to environmental remediation of extent contamination on the other.

The problem came to the political forefront in the United States in the decade of the 1970s and achieved enormous and widespread notoriety with the discovery of such hazardous waste sites as the infamous Love Canal site in Buffalo, New York, and a variety of other sites in the United States which brought home both to the electorate in graphic fashion and thereafter derivatively to the legislature in perhaps an even more graphic fashion, the necessity to address the second conceptual problem of environmental law. This is as follows: as developed societies how do we clean up the environment, not simply how do we resist further degradation, but how do we clean up the contamination already there and the secondary question of how do we distribute fairly, rationally, equitably or sensibly any or all of the above the costs attendant to that?

It is, I should note at the outset, a task of daunting proportions. While estimates of unit cost in my area are notoriously unreliable, I would be the last to suggest that you should believe what you read in the newspapers, ***Time Magazine***, or ***The Economist*** about the unit cost of environmental clean-up, they are uniformly high. And while estimates in the United States are not particularly reliable, they range into the hundreds of billions of dollars of potential cost to be incurred in order to remediate contamination already distributed into the environment.

Well, there are of course as I am sure you will recognise, a variety of structural alternatives which would be available to a legislature in dealing with such a problem. On the one hand, and at one end of the spectrum, it could under some circumstances be an entirely rational posture for such a legislature to suggest that because the benefits attendant on the industrialised and agricultural activities which had created the contamination in the first place were so widely disseminated across the society as a whole, that the sensible way in which to finance remediation of the environment was simply to do so out of the general tax revenues. To allow government agencies to establish policies and priorities to allow them to simply spend from the general taxes the amounts necessary to do so.

While there may be a certain logic and perhaps even a compelling moral logic underlying that proposition, it has not been politically saleable for an instant in the United States, in any of the nations of the European Community, or in any of the other developed countries which have come to consider this question of how to distribute the costs of remediation. Instead the political dialectic has in essence forced upon our legislators in the United States and increasingly in Europe as well, the posture that such regulation and such statute ought to be animated by the principle, the polluter should pay. While that is a principle easily stated, while it is a principle susceptible of broad public political support, it is in the end a fallible guideline for remediation for a variety of practical reasons which you as lawyers and financing officers and members in general of the business community will readily recognise.

First of all it is, from the technical side of the spectrum, virtually impossible to identify the source of a given area of contamination. It may not be readily attributable to any nearby industry. It may in fact represent run-off. It may have been transported in the economy. It may have been transported in the environment. It is not always possible to find out in short where contamination arose.

Second, as we will all recognise in the practice of our ordinary commercial pursuits, the only constant is such change. At the remove of what may be 100 years, it is virtually impossible even if you can identify a particular organisation or entity or person as having caused contamination, it may be impossible to find them. On the organisational side, the corporation may have been dissolved long since, it may have been merged, it may have gone bankrupt, it may have been declared insolvent, it may have ceased its operations, it may have sold five times ago in the chain of title the operations attendant to a particular site.

In short, the array of problems attendant to administering a true fault based system for the distribution of remediation costs are so great that it was early recognised in the US legislatures consideration of these issues, that a fault based system while politically popular would in fact ultimately come back to haunt the legislature because it would result in a system in which too few remediations actually took place. And Congress recognised at the start that a much broader net needed to be case.

While it did not abandon the rhetoric and the rhetorical justification of the polluter shall pay, in fact it cast a far broader net and created a system in our so-called "Superfund" or surplus statute - the Resource Conservation Recovery Act, a system which provides for liability, without regard to fault and without regard to polluting activity in some ways for a variety of categories of individual or entity. The first of these is imposed on those who own or operate sites; the second on those who have contributed to contamination at sites; the third on those who have transported contamination to sites.

Then it went farther, because had they done only so much and stopped, the statute would not have its present character and would not have its present direct impact on financing transactions. But indeed they went farther because they made the liability in the statute joint, several, strict and retroactive, thereby allowing the government in the exercise of its responsibility to compel site remediation activities to seek the entire cost of remediation and to impose the entire burden of remediation on any person or entity in any of those defined categories.

The statute leaves open, and indeed there is fierce and extensive litigation on the point, claims over and against third parties. Typically that is the first response of someone who gets a notice as a responsible party under a Superfund site remediation programme. But the claim over proceeds at your own cost and your own risk and as between the entity and the government the liability is strict, joint, several, retroactive and absolute.

Now in fact this sounds draconian and in fact it sounds almost unworkable. But I would suggest to you that it represents a political judgment and a structural political accommodation which will not readily be avoided and in fact which is coming into play in the laws of other European countries, is foreshadowed in the EC's directive on hazardous waste issues. It is also clearly present in the United Kingdom where the owner or occupier of a facility may be the subject of an abatement order and nothing in the statute in which that phrase exists suggests that there is any required nexus between that owner or occupier's present tenancy and the creation of the contamination which is the subject of the abatement order. The same in fact holds true in New Zealand's proposed Resources Management Bill in which the same abatement order authority is given again in the absence of any particular nexus of fault or liability for the contamination. That sensible social policy viewed in one level, is I suspect a political accommodation which will spread far beyond the United States by virtue of the difficulty legislatures in all of the democratic countries will have with the increasing demand on the part of the electorate to compel remediation activities on the one hand and the difficulties of actually establishing a workable fault based system on the other.

It may well be that the US system will not be replicated precisely; indeed I hope you can avoid many of our more egregious errors; but something like it will likely characterise the environmental statutes and regulatory authorities of all of the developed world.

The third wave in American environmental law is one which we are now at this very moment embarked upon and that is an interesting one because it involves a return to the historical origins of American environmental law and to a revisiting of the emissions regulation model for environmental regulation, but at a vastly more stringent, costly and capital intensive level. We have in the United States recently passed a series of far reaching amendments to the Clean Air Act, our Congress will take up in the next year similar amendments to the Clean Water Act, and in many respects the low hanging fruit from the boughs of the regulatory tree has long since been snatched by the regulators. In these amendments and in the current wave we are reaching far beyond and it is the consensus among those who observe this phenomenon that capital costs and operating costs will rise proportionately.

Indeed when Moody's issued the investors advisory to which I adverted earlier, it chose to ground its cautionary message upon all three of these waves: first, upon the on-going costs of compliance with existing Clean Air and Clean Water Act regulations; second, upon the prospect of significant remediation obligations coming to roost in various companies at various times and in various ways; and third, upon the foreseen additional capital costs and expenditures attendant to the next level of ratcheting down, which in some respects represents an order of magnitude phase shift for us in this third wave.

Having given you a little bit of a thumbnail sketch of these three ideas, these three sorts of waves of enactment, the question is how does all of this bear on the financing transaction? And the answer to that is, it bears on the financing transaction in several important ways.

First of all, of course, it is in many respects a truism to suggest that issues of this economic moment have a direct relationship upon company valuations. They have a direct relationship upon companies' income statements, and they have a direct relationship to companies' balance sheets. That in and of itself is sufficient reason for those in a position to make and those responsible for financing decisions to take note of them. It is also true that neither in the United States nor in any of the other developed countries have we yet been able to develop an effective language of environmental disclosure or indeed of environmental accounting. You can peruse the annual reports, you can peruse the quarterly filings required of public issuers in the United States capital markets, you can peruse the certified financial statements subscribed to by chartered accountants and certified public accountants in the United States, in blissful ignorance of the nature, extent and variety of environmental contingent liabilities reasonably to be expected in those companies.

That is not because either the companies or the ancillary professions of law and accounting have consciously sought to mislead. It is because we are at a very primitive state in figuring out ways and categories and sensible mechanisms for making these disclosures. Even the best intentioned companies and even the best intentioned advisers are going to be in difficulty trying to fit the burden of these environmental responsibilities into the currently accepted forms under generally accepted accounting principles and into the currently accepted and mandated disclosure language which is typically required by securities regulators in the United States and in other countries as well.

So at the outset, the lending institution or the investor, or the secondary market investor, is faced with a situation in which the database about environmental issues as they relate to a particular company is likely to be woefully insufficient. That will obviously change over the next ten years. I view it as one of the most important tasks for the international business community to begin the process of developing more sensible standards, standards which neither penalise candour, but nevertheless fairly portray potential continent liabilities in a sensible and uniform fashion. But we are nowhere near there yet. So ***ab initio*** at the moment that the financing decision and the credit issue is being underwritten, the nominal lender is proceeding in a grater degree of ignorance than one would like to see and in a greater degree of ignorance than would be the case with regard to other commercial issues which have as their background hundreds of years of case law and accounting and legal exploration to which Sir Robin referred to this morning.

At the time that the credit is first under consideration, therefore the first issue from the lending institution's point of view is as follows: is the business at which we are looking, either as investor or as lender, in compliance with environmental laws and regulations at this moment? Can we take a snapshot of its compliance posture and assure ourselves that the business may in fact lawfully operate? The consequences of unlawful operation are draconian indeed in the United States - as well they should be. They are becoming increasingly stringent here, in Australia, and in all of the European Community countries, and it is simply not to be countenanced that a prudent lender would take the risk, under many, perhaps not all but under many circumstances of a significant failure of compliance at the credit underwriting time.

So that is the first issue - the question of whether the business is now presently in compliance with environmental norms.

The second issue for the lender, however, is a little more difficult and equally important. What is going to happen in the future? What will happen over the term of the credit? In what ways will the credit be returned? Is the credit going to be taken out by other lenders? Is the idea that the credit will continue over a long period of time? Is it a defined term credit? And once you have answered the question of what your risk profile is over time, then you need also to address, it seems to us in the United States and it seems to the lenders in the United States, the question of future compliance and on-going compliance. What levels of capital expenditure will be required to maintain the posture of compliance? To what degree are the plans of the business which are embodied in the economic projections on the basis of which the credit is being evaluated, dependent upon an increase in production of 30%, a significant change in the product in the product mixture, alternations in the way the business operates, or even the continuation of potentially marginal operations from an environmental point of view - those which are already butting right up against the limits of the regulatory envelope?

And in order to have a sense of the economic value of the credit simply viewed from an income stream perspective, both the question of current compliance and this question of on-going future compliance must needs be addressed. But even beyond that, there exists the third issue from the lender's perspective and an issue which is of grave significance given the structural problem of the mechanisms which we in the United States and which other countries as well have selected for the distribution of remediation costs. That is what and under what circumstances might the company to which I am lending come under a mandatory order for significant site remediation expenditure? And that of course is an issue which has several dimensions from the perspective of the lender? In the most simple nominal financing transaction in a secured financing it may in fact be the very collateral upon which the lender is relying if all else fails and the income stream fails that becomes the subject of the order. In fact the value of the collateral simply viewed from the market perspective may be deeply impaired at the time of the credit by such contamination, but not to the knowledge of the lender and possibly not even to the knowledge of the borrower.

Second of course, even apart from the simple nominal secured financing mechanism, you have also the question of whether the borrower will be forced on an unpredictable and perhaps an exaggeratedly rapid time frame to expend the kinds of enormous sums which may be required for environmental remediation.

So, from the lender's perspective, these are issues which bear directly upon the original credit underwriting decisions in various ways. They are however, because we live in an on-going world and an imperfect one, and because these issues have developed over time. It is also an issue for lenders who are managing troubled credits or who are managing untroubled credits of an on-going nature, because there are many lenders in the United States and elsewhere who have significant exposures to business entities where these issues were in fact not adequately addressed at the time that the credit was underwritten or indeed where the credit was underwritten at a time when the regulatory and statutory demands potentially placed upon the borrower were not of the same character that we would now see today. Under those circumstances there is in addition to the new credit, a significant issue for lenders in terms of the management of their own portfolios, both as far as the secondary market is concerned and as far as the management and guidance and help that they may be to their borrowers.

Now, in addition in the United States (if that is not a large enough burden to lay upon the lending community already battered in the United States and elsewhere by economic turns in fortune), there has developed over time a most interesting and significant sub-species of this analysis which has under some circumstances attributed the liabilities of the borrowers directly to the lenders. There are circumstances in United States law (and I suspect there will become circumstances in the laws of other countries) under which lenders may in fact wind up having attributed to them some or all of the environmental compliance responsibilities of their borrowers, particularly in the troubled credit situation.

In the United States (and I would like to explore this in our own American context) this issue has arisen by virtue of the way in which the Superfund statute and the forty or so clone statutes which our several States in our federal system have enacted, defines the word "owner" or "operator". The way in which it defines them is that it did not. It left the question of what an owner or what an operator was entirely to the development of case law.

Congress recognised at the commencement of the operation of the Superfund statute that to leave this definition so widely open for the development by the lower Federal Courts posed a potentially acute burden to a certain small category of lenders in the United States. There are States in the United States where by virtue of the local laws of that State mortgages are not recognised. In fact in those States a deed in trust is actually accepted by the lending institutions in order to serve the same security function of a mortgage. Congress recognised, because it was brought to their attention by the legislators from a couple of those States, that something needed to be put into the statute to address this issue. Language was inserted into the Bill suggesting that a lender who holds indicia of ownership in an entity solely in order to protect its security interest in an underlying advancement of credit, is not to be treated solely for that reason as an owner. But that is as far as Congress chose to go.

This "gap" left open for case law development two areas which have come to assume a signal of importance to us in the financing side of our practice. The first of those is this: what happens when the lender extends the loan and takes some form of indicia of ownership in order to secure the extension of credit, but is not thereby the owner or operator if the credit "becomes troubled", the remedies contained in the credit agreement are exercised, and the property is taken by the lender? Does that lender take the property subject to some "safe harbour"? Is the lender to be treated differently because it has taken the property in foreclosure to every other type of owner or operator under United States law? Or is the lender simply to make an evaluation, indeed a risk evaluation at the time of the exercise of its remedies as to whether it makes sense to actually own this property? Or should the lender simply be put to that election?

The lower Federal Courts differed on this issue. There grew up a rule of a handful of cases suggesting that lenders who took property in foreclosure, which was contaminated and subject to these remediation orders; and who thereafter did nothing but maintain the property in a most limited fashion, then reselling it quickly, within a time period such as four months or six months, was not going to be treated as an owner or operator for purposes of the Superfund statute. There might be a little window through which the artful lender with an excellent real estate broker on its staff might slip.

The second line of cases was the question of not so much whether a lender might by virtue of its activities in foreclosure become an owner pursuant to the Superfund statute, but rather whether the lender might by virtue of its activities become an operator. That issue in many respects poses more difficult questions. We have to get to the essence of the lender's exercise of its rights under the credit agreement in the work-out context. When the credit is "troubled", when the lender's interests are most in peril, when the lender is to exercise of the rights it won so dearly across the bargaining table at the time the credit agreement was negotiated, that is when it is most greatly at risk for purposes of these environmental statutes, of being deemed to be the operator of the facility, and thereby taking on a liability. It is important to note that under either hypothesis the liability which we are discussing bears no relationship whatsoever to the amount of the credit. It is not in any sense limited by the amount of the credit, and there are frequently instances in which a $10,000,000 credit followed by a foreclosure, followed by ownership brings with it in train a $100,000,000 liability. There is no relationship whatsoever between the nature of the environmental claims which may be made against the property and the nature of the underlying credit advanced by the lending institution.

Our Federal Court of Appeal for the 11th Circuit first came to deal with this issue of the work-out lender in 1990 in the ***Fleet Factors*** case. That case set "the fox among the chickens", because that court held, in a preliminary motion, not after trial on the merits, that a lender who had sufficient rights under the credit agreement to control the debtor's business, rights sufficient from which an inference, said the court, might be drawn that the lender could, if it had chosen to do so, have affected the debtor's conduct of its environmental affairs, were rights sufficient to make that lender an operator for purposes of the Superfund statute - in a case in which no foreclosure had actually been made and the title to the property remained where it had always been - ie, with the borrower!

That decision led to a "fire-storm" because it is perhaps the furthest extension of this potential doctrine which has yet been had in the American courts. What happened after the ***Fleet Factors*** case is interesting and instructive. Several later cases diverged and have come to a more sensible formulation, again not a satisfactory one, but still a formulation which comes closer to the question of looking at the ***actual*** control the lender exercises over every aspect of the debtor's business under these circumstances. Moreover, a variety of senators and congressmen have submitted Bills to Congress which purport to solve this problem by creating one or another "safe havens" for lenders under these circumstances. In addition, the EPA, the agency charged with administering the statute, has come out with a proposed draft rule which suggest that a lender who exercises the typical rights given to it in a work-out situation under a credit agreement will not thereby become the operator, for purposes of these statutes.

The future of the legislative enactments which purport to solve this problem is very uncertain. The politics are complicated. Industry by and large is opposed to piecemeal amendment of Superfund because they are concerned that vast categories of potentially responsible private third party defendants may vanish from the scene in the event that Congress begins to amend in favour of particular industry groups. The administration is deeply opposed to piecemeal amendment of the Superfund statute, and what we may wind up with is a legislative stalemate for a couple of years, the development of spotty case law on the question of the meaning of "owner" or "operator", and an EPA rule which is issued which binds only EPA's own staff and does not bind third party plaintiffs. We may wind up with a truly curious and rather anarchic set of laws on this subject.

Finally, I would like to mention that there is developing in the United States an independent line of case law beginning with a case called ***O'Neil v QLCRI*** which suggests that even in the absence of Superfund claims and even in the absence of environmental remediation claims, lenders may have direct responsibility for the maintenance of environmental on-going compliance under the first wave theory. Under these cases it has been held that a lender who lends into a business which is out of compliance, and who thereafter during the term of the credit does nothing to urge its borrower into greater compliance, does nothing to condition continued extension or refreshment of the credit upon the maintenance of continued compliance, may by those acts become an ***aider*** and ***abettor*** in the violation of environmental laws with which the borrower was concerned.

I think the sensible way to look at this last species of lender liability issues is to say they represent a "marginal" case. It is a real case, but it is a marginal case, and that the underlying issue and the most important issue from the perspective of the lender, must be the issue of economic valuation. The complexities of environmental analysis, the difficulties of the environmental audit process which are well beyond the scope of my paper today, are legion. I would not want you think that I believe that such issues were simple.

I would like, however, to leave you with the thought that fundamentally environmental issues, pressing as they are, significant as they are, and ultimately giving rise in some instances to questions at the heart of the credit analysis, simply represent another species of commercial risk that the lender must evaluate. The bedrock fundamentals which the lending community and its advisers, both in the professions of accountancy and law have developed to deal with these commercial risks, apply to this area as well. The issue is management. The ultimate test, it seems to me, of the soundness of a credit, prospectively viewed, the ultimate test of the way a credit is managed, is the question of whether the lender is truly able to satisfy itself that the borrower is managing the relevant responsibilities in a sound and sensible way. Does the borrower understand them? Does the borrower have a handle on them? Is the borrower acting in a proactive fashion to anticipate and to shape the compliance picture? It is, viewed in this perspective, another species of commercial risk with regard to which no-one should throw up his or her hands and give it up "as a bad job". In point of fact it is exactly the kind of thing that lenders can and should deal with. It is exactly the complexity and level of issues that their advisers can help them with. In the end, it is perhaps the single most important goad towards building the better environment which we and our children will require.