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FEDERAL DEPOSIT INSURANCE CORPORATION

TESTIMONY OF

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ON

ENVIRONMENTAL LENDER LIABILITY

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

2:00 PM
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Room 538, Dirksen Senate Office Building

Good afternoon, Mr. Chairman and members of the Committee. We appreciate this opportunity to present the views of the Federal Deposit Insurance Corporation on lender liability for hazardous substance clean up costs and damages. The concerns and views raised in our testimony are also shared by the Resolution Trust Corporation. We understand the RTC will be submitting its own statement to the Committee.

The primary federal laws which impose liability on the basis of hazardous substances are the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) or, as it is commonly called, "Superfund," and the Resource Conservation and Recovery Act (RCRA). The FDIC is very concerned about lenders' potential liability under federal and various state environmental laws. As the insurer of banks and thrifts, as well as the receiver or liquidator of failed banks and thrifts, we believe the federal deposit insurance system should not be threatened as a result of environmental liability assessments. As the primary federal supervisor for almost 8,000 state-chartered nonmember commercial and savings banks with over one trillion dollars in assets, we are anxious to see that the safety and soundness of the banking and thrift system are not threatened as a result of lender liability under such laws.

On the whole, the FDIC and RTC support the "Lender Liability Act of 1990" (Subtitle B of S. 2827). The legislation would limit the diversion of deposit insurance funds from their primary purpose -- the protection of depositors -- and limit the escalating costs of

resolving failed and failing savings and loans. The FDIC is concerned about the protection of our environment. But, the environmental laws, as presently interpreted, also pose significant risks to our goal of protecting depositors. We believe it is extremely important that we not divert deposit insurance monies from their primary purpose, no matter how laudable the other goal.

Our testimony will provide background on how the FDIC may become directly involved with property which poses problems under current environmental laws. We then will address the risk to the FDIC and FDIC-insured lenders from potential environmental liability claims. We will discuss generally how lenders have responded to the risks arising under current environmental law. In addition, we will address the risk of loss to other agencies or instrumentalities of the Federal government. Finally, we will comment on proposed legislation to provide relief from environmental lender liability.

<u>BACKGROUND</u>

At the time of the FDIC's appointment as receiver of a failed bank, all assets of the failed institution come to the FDIC for liquidation. If the resolution of the failed institution is a purchase and assumption transaction, the assuming financial institution may purchase some or all of the assets of the failed institution. Even as to those assets assumed, the assuming institution may later put some assets back to the FDIC.

Unsold assets, or those "putback" to the FDIC, may include non-performing loans, as well as real estate owned by the institution as a result of foreclosure on collateral (generally termed, "owned real estate"). Thus, even under a purchase and assumption transaction, some assets -- such as secured notes and owned real estate -- may remain with, or be put back to, the FDIC. We attempt to confine these assets, and any potential liabilities associated with them, to the failed institution's receivership estate. This is done in order to prevent access to, and protect, the deposit insurance fund.

With regard to these retained assets, the FDIC as receiver is generally regarded as "standing in the shoes" of the failed institution. Although no cases have yet been decided in this area, we are concerned that the FDIC, as to these assets, may be treated just like any lender under the environmental laws. We are also concerned that a court may someday determine that the FDIC, in its corporate capacity as well, is responsible for a receivership's environmental liabilities. Indeed, if the FDIC in its corporate capacity ever becomes directly liable for environmental claims, our resources -- designed to protect depositors -- could be imperiled.

In summary, whether or not a purchase and assumption transaction is effected, the FDIC may find that it holds assets plagued by environmental problems. Furthermore, we may even find that some of these assets have outstanding Superfund liens against them. Clearly, current environmental laws may directly affect the soundness of the

federal deposit insurance funds and the stability of the deposit insurance system generally.

RISKS TO THE DEPOSIT INSURANCE FUNDS

The Environmental Protection Agency (EPA) has identified more than 30,000 Superfund sites in this country. As the EPA cleans up these sites, it is expected that litigation will escalate as the EPA seeks to shift clean-up costs, as it is statutorily required to do, to those originally responsible for the improper disposal.

At some point it will be argued that the FDIC is liable for the clean-up costs of a particular hazardous substance site, even though the FDIC did not originally create the problem. If a court upheld that argument, this liability would directly affect the insurance funds or increase the cost of resolving failed and failing savings and loans. This would be true particularly if the FDIC and the RTC in their corporate capacities are found to be chargeable with the liability.

The stability of the deposit insurance funds also may be adversely affected indirectly. The number of failures of insured financial institutions may increase due to lender liability for hazardous substance clean-ups. In turn, the financial condition of the deposit insurance funds would be weakened. Further, because environmental contamination problems, or the threat thereof, may lower the sale price of properties, the FDIC's recoveries from receivership

liquidations will decrease. Finally, to the extent that receivership estates are diminished by liabilities for clean-up costs, these receivership estates may not be able to repay the monies originally lent to them by the deposit insurance funds.

The FDIC does not face environmental liability risks because we created hazardous wastes or improperly disposed of these materials. Instead, we face these potential liabilities as a result of our being an involuntary "owner or operator" of properties -- for however short a period of time these properties may be in our control -- and because wastes were released or deposited on those properties by others in the past.

The extent to which we are placed at risk depends largely upon the assets we hold. The more banks and thrifts that fail, the greater the potential for the assertion of environmental liability claims against the FDIC and the RTC, due to the sheer numbers of assets held. As this Committee knows, the number of banks and thrifts that have failed since 1983 has risen steadily. At this time, the FDIC is responsible for liquidating assets from 994 failed banks and 99 failed thrifts. The FDIC presently holds in its various capacities a total of approximately $13.2 billion in real estate related assets. The FDIC is also liable for approximately $5.5 billion in real estate related assets resulting from large assisted bank transactions. Further, the FDIC has approximately $13.8 billion in real estate related assets resulting from the FSLIC assistance agreements. The RTC also has a vast number of institutions and assets under its

jurisdiction. They can provide the Committee with their numbers.

As the FDIC seeks to resolve failed financial institutions, interested purchasers increasingly raise concerns about potential environmental liability. At times, these buyers seek indemnifications from the FDIC for potential environmental liability claims. At other times, they seek drastic reductions in price to accommodate their concerns for environmental risks. Ultimately, some buyers just refuse to purchase certain assets which they identify as having potential environmental liability claims. Because of buyers' concerns, we may carve out assets in some cases, choosing not to even attempt to transfer them. Too often it is the FDIC -- and, thus, the deposit insurance funds or the taxpayer -- that are left "holding the bag."

To date, the FDIC has been fortunate. Relatively few of our assets, to our knowledge, contain hazardous substance problems. Of the total assets held by the FDIC for liquidation, approximately 270 assets -- with a total book value of about $365 million -- have been identified at this time as potentially having hazardous substance problems. We have obtained clean-up estimates for approximately 50 of these properties and have been told that these costs may be more than three times the market value of these properties.

The FDIC holds other assets which may pose problems under other environmental laws. For example, the FDIC has an interest in more than 200 assets -- with a total book value of about $300 million --

which may have asbestos problems. We are not addressing these types of problems today because they are not generally affected by Senator Garn's bill. Yet, in considering this legislative initiative further, we urge you to consider expansion of S. 2827 so that it addresses these problems as well.

Inability to collect the principal of an asset is one thing. But, findings of Superfund liability on top of that could jeopardize the financial soundness of a financial institution and the deposit insurance system. Superfund liability assessments and the expenses incurred in litigating Superfund cases can be enormous. Given the large numbers of properties for which the FDIC is responsible, it can be anticipated that the FDIC may be compelled to incur these high Superfund clean-up costs, attorney fees, engineering fees and the like -- absent legislative change.

Further, the FDIC may be held liable for these costs -- even if the banks or thrifts involved failed years ago. As a case in point, we will describe briefly a lawsuit filed last year under CERCLA and RCRA.

Plaintiffs in the pending case seek damages of approximately $6 million based on allegations that hazardous substances were released beginning in the early 1950's on property they now own. The hazardous substances allegedly were found on the property in the late 1980's, and the current owners sued numerous prior owners and operators of the property.

In 1957 and 1959, legal title to portions of this property was transferred to a bank for the benefit of an employee's profit sharing retirement plan. The bank held legal title to the property as trustee of the plan but was not involved in the operation of the property. The property was leased back to the company that established the plan, pursuant to various leases.

Plaintiffs do not contend that the bank contributed to the alleged contamination. Rather, plaintiffs allege only that the property was contaminated during the time that the bank held record title. In 1973, the bank failed, the FDIC was appointed receiver, and the bank was sold under a purchase and assumption transaction. The FDIC became party to the lawsuit due solely to its brief role, in 1973, as receiver of the failed bank.

In this case, it appears that the FDIC may be able to avoid ongoing legal fees, engineering fees and payment of cleanup costs due to a fortuitous indemnification clause in the various leases. While this particular case should conclude with relatively moderate expense to the FDIC, we most certainly shall not always be so fortunate. In many cases, the FDIC will succeed to property interests without the benefit of such an indemnity.

RISKS TO LENDERS

The FDIC has additional exposure to the environmental laws that arise from the risk to lenders. Lenders are faced with the specter of enormous liability assessments under current environmental laws which

deal with hazardous substances. This is particularly true today, in light of a recent decision of the United States Court of Appeals for the Eleventh Circuit. In United States v. Fleet Factors Corporation ("Fleet Factors"), the Circuit Court held that a lender can be held liable for Superfund clean up costs solely on the basis of the lender's participation in the financial management of a facility. In reaching its decision, the Court made what has been described as an "extraordinary interpretation" of various sections of CERCLA. Even without the Fleet Factors decision, lenders face significant risks under the various federal environmental laws which deal with hazardous substances.

In addition, most states now have laws that parallel CERCLA and RCRA. Some of these state laws are even more onerous than the federal laws because they impose "Superliens" on properties subject to clean-up.

A lender may become liable under Superfund as a result of being a present or past owner of property, or if it is found to be an "operator" of a facility, where hazardous substances have been improperly released, stored or deposited. Once a lender forecloses on collateral, or otherwise obtains title to a borrower's property, the lender may become liable immediately for any costs incurred to remediate that property -- simply by virtue of its being the "current owner" of the property. The duration of the ownership -- however brief -- does not matter.

Moreover, Superfund does not specify the standard of liability that will be used to determine who is liable for clean up costs. It also does not describe or require a causal link for liability to attach. Nevertheless, the courts have determined that the standard of liability under Superfund is that of strict liability. Thus, subject only to certain very narrow defenses, a lender will be liable for Superfund clean up costs and damages the moment it becomes the owner of contaminated property.

A lender also may be held liable for Superfund costs and damages if it was a past owner of contaminated property. In fact, as the statute is interpreted, virtually any person in the property's chain of title following contamination may potentially be held liable. Thus, if a lender was a past owner of a property at any point after it became contaminated <u>and if</u> it can be asserted that barrels on the property containing toxic wastes, for example, continued to leak while the lender was the owner of the property, then the lender may be liable under Superfund.

A lender can attempt to take advantage of the limited number of statutory defenses available under Superfund. However, the lender's burden of proof is very high, since the courts have consistently construed these defenses very narrowly. The primary defense that lenders, as well as others, may raise is commonly called the "innocent purchaser" defense. This defense excludes lenders from Superfund liability if they can establish that: (1) they acquired the

property after the hazardous substance disposal had occurred; and, (2) they did not know, and had no reason to know, that hazardous substances had been disposed on the property.

This latter requirement has been the subject of much judicial interpretation and has led to the development of a whole new industry. Lenders now must regularly undertake expensive environmental audits of properties before foreclosure, if they hope to later successfully raise the innocent purchaser defense. Even if an environmental due diligence audit is undertaken, uncertainty remains. No guidance is provided under the law or regulation as to what constitutes the "all appropriate inquiry" required to be protected from environmental liability. Finally, because of the expenses involved in attempting to establish the "innocent purchaser" defense, it is, ironically, somewhat punitive itself.

The situation is exacerbated by the recent Fleet Factors decision. The Court in this case interpreted a section of Superfund, which expressly excludes from the definition of "owner or operator" 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 U.S.C. Section 9601(20)(A)]. In the past, lenders believed this section provided protection from Superfund liability, so long as they did not participate in the operation of a facility. Lenders also generally understood that their risk of being held liable as an "operator" was a function of the nature and degree of their control over the

operations of a borrower's facility. More specifically, lenders generally thought that lender liability would not attach under Superfund unless they were involved in the day-to-day operations of a facility. In short, liability rested with the responsible, controlling party -- the owner/operator -- and lenders would be held liable only if evidence could be advanced similar to that presented in other, traditional lender liability suits.

However, the Court in Fleet Factors held that a secured creditor need not be involved in the day-to-day operations of a facility or actually participate in the borrower's decisions relating to hazardous waste management. Instead, a lender will be liable if the lender is participating in the financial management of a facility to such a degree as to permit the inference that the lender could influence the borrower's waste management decisions.

The Fleet Factors decision may have an enormous impact on lenders, particularly if the decision is adopted by other circuits. Lenders may have to change their loan underwriting practices and how they deal with defaulted borrowers. Further, just as federal banking agencies are encouraging banks and thrifts to manage their loan portfolios more carefully, the decision in Fleet Factors may signal to lenders that they should be less involved in overseeing borrowers. Should this occur, the FDIC's goals of promoting the safety and soundness of the banking and thrift system, and the viability of the deposit insurance system, may be frustrated.

LENDERS RESPONSE TO THE RISKS

Lenders clearly face significant potential risks under current environmental laws and court rulings. Irrespective of the size of a loan, a Superfund lawsuit could result in a claim that is in excess of a lender's net worth. While an individual charge-off is a normal occurrence and can be managed, a Superfund lawsuit could cause the insolvency of an insured institution.

Lenders have attempted to control their environmental risks in a number of ways. Almost all large institutions address hazardous wastes and other environmental problems in their loan policies and/or procedures manuals. Smaller lenders usually deal with the environmental issues on an ad hoc basis, seeking outside advice when necessary. Before a credit decision is made, financial institutions often conduct environmental audits on potential loan customers that are involved in some way with hazardous wastes. If the borrower is unable to repay the loan, many banks assess potential environmental risk before restructuring the loan or foreclosing on real estate held as collateral.

While lenders are aware of environmental risk and have taken action to limit their liability, the adequacy of the preventive measures cannot be evaluated because lender responsibility under Superfund legislation remains undefined. Various court interpretations indicate that almost any current or past owner could be held liable

for the cost of the cleanup, whether or not that owner was in any way responsible for the problem. It also is possible that a lender might incur liability even if it does not take possession of real property. Because the issues are still evolving, what is considered a prudent action by the lender today might become a cause of action tomorrow.

Unless the law is changed to exempt insured depository institutions and the FDIC and RTC from this potential but unrealized liability, it is possible that the next court ruling or regulation may have an unfavorable systemic impact on banks, savings and loans, and the deposit insurance funds.

RISKS OF LOSS TO AGENCIES OR INSTRUMENTALITIES OF THE FEDERAL GOVERNMENT

As discussed previously, there are several risks of loss to the FDIC and RTC that arise by reason of lenders' risks. The environmental liability that lenders face will place an increasing burden on the deposit insurance funds by accelerating, if not being solely responsible for, the capital depletion and insolvency of some insured depository institutions. Because lenders may understandably be unwilling to foreclose on collateral known to be contaminated, such loans effectively become unsecured. All of these factors may contribute to increased insolvencies.

In addition, the transactional costs associated with making loans are increased by the need to conduct environmental due diligence audits. Under the current state of the environmental laws, such audits must be conducted repeatedly -- before making a loan, renewing a loan, engaging in a workout with a borrower in default, and foreclosing on collateral. The simplest due diligence investigation can cost between $3,000 and $10,000 each and a lender may be required to perform hundreds of these due diligence investigations every year. This transactional cost may strain a financial institution's financial condition and most certainly lenders will attempt to pass the cost on to the customers.

In addition to the cost and risk increases, the potential for environmental liability could have credit allocation consequences that could jeopardize the ability of certain segments of the economy to obtain financing and, therefore, to operate.

We are unable to comment extensively about the risks of loss that agencies or instrumentalities of the Federal Government, like the Small Business Administration, for example, may face as a result of the risks to lenders. We imagine that the Small Business Administration may find that more small businesses, such as dry cleaners, are defaulting on their loans due to increased operating costs arising from environmental laws. Also, if lenders refuse to foreclose on collateral because of contamination, this may have some impact on agencies such as the Farmers Home Administration, the Federal Housing Administration, and the Small Business Administration that insure or guarantee these loans.

LEGISLATIVE PROPOSALS

S. 2827 (Subtitle B), "Lender Liability Act of 1990"

As stated previously, the FDIC on the whole supports S. 2827. It would limit diversion of deposit insurance funds from their primary purpose and limit escalation of the cost of resolving failed and failing savings and loans to the American taxpayer. However, we believe that the immunity afforded by S. 2827 should be strengthened. A detailed discussion of the individual provisions of S. 2827, as well as recommended amendments, are contained in an attachment to this statement. At this time, however, we would like to highlight three of our greatest concerns.

First, we have concerns about the provisions that deprive the FDIC and the RTC of immunity from environmental laws if they have either: "caused the release, or threatened release of a hazardous or potentially dangerous substance" or had "actual knowledge that a hazardous or potentially dangerous substance was located on [a] property but failed to take all reasonable actions necessary to prevent the release of such substances."

We believe these provisions are overly broad and ambiguous. They could open the FDIC and RTC to expensive and unnecessary litigation on their intended scope, as well as to liability for environmental clean-up costs in circumstances not intended by Congress. For example, the requirement that the FDIC and the RTC take "all reasonable actions necessary" to prevent the release of a substance,

if interpreted broadly by the courts, could entirely eviscerate the purpose of S. 2827 to grant a Superfund exception for the FDIC and the RTC. We suggest that these provisions be more clearly defined or narrowed to ensure that they do not undo the basic thrust of S. 2827. We have some suggestions in the attachment to this testimony, and we would be happy to work further with the members of this Committee to draft appropriate language.

Second, we suggest inclusion of language to clarify that the immunity granted the FDIC and the RTC <u>extends to those who purchase contaminated property from the FDIC or the RTC</u>. The bill is ambiguous on this point. As previously discussed, the deposit insurance funds and the cost of the savings and loan bailout may be adversely affected to the extent that we cannot sell properties. So that we are not left "holding the bag" and to ensure that properties in our hands are indeed marketable, the immunity afforded the FDIC and the RTC <u>must be transferable</u> to those who buy contaminated properties from us.

Finally, it is unclear exactly what laws will be affected by the immunity granted the FDIC and the RTC under S. 2827. As drafted, the bill provides the FDIC and the RTC with immunity from "any law imposing strict liability for the release... of hazardous substances...." The language, "<u>any law</u>," may invite disputes regarding the scope of the immunity. We suggest that either the law or the legislative history reflect clearly that "any law" encompasses "any federal, state or local statute, regulation, rule, ordinance or

common law." This will clarify that the FDIC and RTC are immune not only from federal laws dealing with hazardous substances but also similar laws and regulations of other governmental units.

The foregoing amendments, as well as those contained in the attachment to this statement, are suggested to strengthen the immunity afforded the FDIC and the RTC under S. 2827. To the extent that we can minimize judicial interpretation of the bill once enacted, we will be able to save litigation-related expenditures.

H.R. 4494

While we support the bill introduced by Congressman LaFalce, H.R. 4494, it is not clear that the protection afforded to lending institutions by that bill would extend to the FDIC and the RTC.

H.R. 4494 protects those who make loans secured by properties affected by Superfund. However, neither the FDIC nor the RTC typically make secured loans. As a result, H.R. 4494 is not adequate to protect those agencies. In addition, H.R. 4494 does not provide any exemption from liability under other federal environmental laws, such as the Resource, Conservation and Recovery Act -- nor does it limit lenders' potential liability under state environmental laws. For any hazardous substance exemption to be fully effective, we believe it must cover not only Superfund but also other related federal environmental laws, state laws, local initiatives and common law.

H.R. 4076, the "Federal Custodial Responsibility Protection Act of 1990

The FDIC generally favors the legislative initiative set forth in H.R. 4076, which was introduced by Congressman Conte. This bill would exempt federal agencies from Superfund liability when they acquire properties through foreclosure and similar means. While H.R. 4076 may provide some measure of relief to the FDIC and RTC, it would not fully protect the deposit insurance funds or limit the costs of the savings and loan bailout. Like the bill introduced by Congressman LaFalce, its exemption is limited to Superfund. As a result, it may not provide protection from suits filed under other federal environmental laws, state laws or common law. In addition, it is not clear that H.R. 4076 would provide the FDIC with protection from Superfund liability when we are acting in our receivership or conservatorship capacity.

CONCLUSION

In conclusion, the FDIC is vitally concerned with the risks posed by hazardous substance claims. The greatest risk of such claims is that they may divert deposit insurance funds, and taxpayers' money allocated to resolve the savings and loan crisis, from their intended purposes. The legislative initiatives now being considered will help ensure that these funds and monies are spent properly. They also will promote the safety and soundness of the banking and thrift system.

We believe that it is altogether appropriate and necessary to exempt the FDIC and the RTC from liability under federal and state environmental laws that deal with hazardous substances and to clarify or limit the instances when a lender can be found liable. The FDIC and RTC were created to safeguard the safety and soundness of the banking system, provide confidence to depositors and handle the savings and loan bailout. They were not created to solve the environmental problems confronting this country. Other agencies were created to deal with these problems and they can do so much more effectively and efficiently. Particularly during these times, the energies and funds of the FDIC and the RTC should not be diverted from their primary missions.

The FDIC and RTC thoroughly support the goals underlying current environmental laws. However, liability for remedying environmental problems certainly should be borne by those who created them and not by banks and thrifts or the FDIC and the RTC. If those who are responsible for the problem are insolvent, then another "insurance fund," if you will, exists to pay for them -- the "Response Trust Fund" created by Congress under Superfund. That Fund, and not the FDIC's insurance funds or the RTC's funds, should bear the cost of environmental problems.