Environmental Risks and Agricultural Lending

Environmental rules and regulations have a significant impact on agricultural lending. For many agricultural lenders, environmental risk may be a larger potential source of cost and losses in their agricultural loan portfolio than traditional sources of credit risk.

Yet, most agricultural lenders don't spend the same amount of time or energy assessing the potential environmental risk of a particular loan request as they do projecting traditional repayment capacity and credit risk. The purpose of this article is to discuss the impacts of environmental rules and regulations on agricultural lending with specific reference to (1) repayment and cash flow, (2) environmental liability, (3) the environmental audit, (4) collateral and foreclosure, (5) reducing environmental risk, and (6) balancing cost and risk.

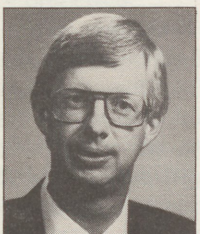
Repayment and Cash Flow

Most environmental regulations do not enhance revenue; they typically increase cost and reduce the cash flow generating capacity of the business. Exceptions to this general rule might include minimum tillage equipment and reduced fertilizer and chemical application rates where excessive applications in the past have increased cost without a compensating increase in yield.

Environmental compliance investments will typically not be financially self-sustaining and will drain revenues from other sources. Thus, loans for environmental compliance must typically be subsidized from revenues generated elsewhere in the farming operation. And even if funds are not borrowed, compliance investments will typically reduce cash flow and income to service currently outstanding debt. Consequently, investments to comply with environmental regulations will almost invariably reduce the cash flow and debt servicing capacity of the business and may thus increase credit risk.

Environmental Liability

In addition to the credit risk already noted, a second and probably more critical risk of environmental regulation is that of envi-



Michael Boehlje is a professor in the Department of Agricultural and Applied Economics, University of Minnesota, St. Paul.

ronmental liability. It should be recognized that environmental liability can occur in all types of agricultural lending, not just in loans made for environmental compliance. A general rule of thumb is that any real estate or facility loan may result in environmental liability, so appropriate analysis and documentation of that prospect should occur.

Two federal statutes, the Resource Conservation and Recovery Act (RCRA) and the Comprehensive Environmental Response Compensation and Liability Act (CERCLA) or, as it is more commonly known, the Superfund Law along with the court interpretations of these statutes and Environmental Protection Agency rules, provide the basic outlines of environmental liability for lenders.

In essence, the rules indicate that a lender has the potential to be liable for environmental damages if: (1) they acquire indicia of ownership through foreclosure or some other procedure, or (2) they become sufficiently involved in management of the property so as to exercise control.

The key defenses against environmental liability for lenders are: (1) the lender has a security interest only in the property (no indicia of ownership or management control), and (2) the lender is an innocent property owner who did not know of the environmental problem, had no reason to know of the problem, and exercised "due diligence" in investigating the property and its history to ascertain whether environmental problems existed.

The courts have provided confusing evidence as to the boundaries of lender liability for environmental problems. In U.S. v. Fleet Factors, 901 F. 2d 1550 (11th Cir., 1990), the courts said, "a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose. Generally, the lenders' capacity to influence a debtor facility's treatment of hazardous wastes will be inferred from the extent of its involvement in the facility's financial management."

Some analysts have interpreted this court as using the test of what the lender could do, rather than what it actually did, in establishing the standard for liability. However, recent Environmental Protection Agency (EPA) regulations challenge and clarify this interpretation.

In Bergsoe Metal Corp., 910 F. 2d 668 (9th Cir., 1990), the court held that "a creditor must, as a threshold matter, exercise actual management authority before it can be held liable for action or inaction which results in the discharge of hazardous waste. Merely having the power to get involved in management, but failing to exercise it, is not enough." Thus, this court held that the standard for liability is clearly what the lender did, not what it could have done.

The Environmental Protection Agency recently (April 29, 1992) published final rules to clarify lender liability for environmental damages under CERCLA. The rules relate specifically to two issues:

(1) What ownership indicia are primarily to protect a security interest and do not subject the lender to environmental liability? And,

(2) What activities are allowed and what are prohibited with respect to participation in management as a defense against environmental liability?

As to indicia of ownership, the rules state:

> ... indicia of ownership may be evidence of a security interest, or of an interest in a security interest or an interest in real or personal property ... examples of such indicia include, but are not limited to, a mortgage, deed of trust, or legal or equitable title obtained pursuant to foreclosure or its equivalents, a surety bond, guarantee of an obligation, title held pursuant to a lease financing transaction in which the lessor does not select initially the leased property, or an assignment, lien, pledge, or other right to or form of encumbrance against property.

(EPA, p. 18374)

To meet the test of whether this indicia of ownership are held primarily to protect a security interest the EPA states:

> In general, a transaction that gives rise to a security interest is one that provides the holder with recourse against real or personal property of the person pledging the security; the purpose of the interest is to secure

the repayment of money, the performance of a duty, or of some other obligation ...

... security interests arise from transactions in which an interest in property is created or established for the purpose of securing a loan or other obligation, and includes mortgages, deeds of trust, liens, and title held pursuant to lease financing transactions. Security interests may also arise from transactions such as sale-and-leasebacks, conditional sales, installment sales, trust receipt transactions, certain assignments, factoring agreements or accounts receivable financing agreements, consignments, among others, provided that the transaction creates or establishes an interest in a vessel or facility for the purpose of securing a loan or other obligation.

(EPA, p. 18375)

In these circumstances of having only a security interest in property, the lender is exempt from environmental liability. But,

When a person holds indicia of ownership in a facility primarily for investment purposes, as opposed to assuring repayment of a loan or as security for some other obligation, the exemption will not apply.

(EPA, p. 18375)

As to participating in the management of a facility,

The general test specifies that a holder is considered to be participating in management ... when it exercises decisionmaking control over the borrower's environmental compliance (such that the holder has undertaken responsibility for the borrower's hazardous substance handling or disposal practices), or where the holder assumes overall management responsibility encompassing the day-to-day decision making of the enterprise.

With respect to the specifically listed activities, a holder acts consistently with holding ownership indicia primarily to protect a security interest, for example, when policing the loan, undertaking financial workout with a borrower where the obligation is in default or in threat of default, or by foreclosing and preparing the facility for sale or liquidation. In addition, the holder is not considered to be acting outside the scope of the exemption by monitoring the borrower's business, or by requiring or conducting on-site inspections and audits of the environmental condition of the facility or the borrower's financial condition, or monitoring other aspects of the facility considered relevant or necessary by the holder, or requiring certification of financial information or compliance with applicable duties, laws or regulations, or requiring other similar actions, provided that the holder does not otherwise participate in the management of the facility, as provided in this regulation. Such oversight and obligations of compliance imposed by the holder are not considered part of the management and operation of a facility.

(EPA, p. 18375)

The EPA rules clarify that,

Actions undertaken by a holder prior to or at the inception of a transaction in which indicia of ownership are held primarily to protect a security interest are irrelevant with respect to the general test of participation in management, and thus are not considered evidence of participation in the management of the facility.

(EPA, p. 18376)

Actions which are consistent with holding ownership indicia primarily to protect a security interest include, but are not limited to, a requirement that the borrower clean up the facility prior to or during the life of the loan or security interest: a requirement of assurance of the borrower's compliance with applicable federal, state, and local environmental or other rules and regulations during the life of the loan or security interest ...

...The inclusion of environmental warranties and convenants (sic) are not considered to be evidence of a holder acting as an insurer or guarantor, and liability cannot be premised on the existence of such terms, or upon the holder's actions that ensure that the facility is managed in an environmentally sound manner ...

...Work out activities are recognized by EPA as a common lender undertaking, and as such these actions will not take a holder outside of the ... security interest exemption, provided that such actions are consistent with the general test of management participation.

(EPA, p. 18377)

The general test adopts a functional approach which focuses on the holder's actual decisionmaking involvement in the operational (as opposed to financial or administrative) affairs of the secured facility …

… management participation does not include the unexercised right to become involved in operational facility decision-making.

(EPA, p. 18379)

As to foreclosure and sale or liquidation,

… a holder is protected by the exemption and is not considered an "owner or operator" of property under this rule only so long as the holder's acquisition pursuant to foreclosure is temporary in nature and the holder is seeking to sell or otherwise divest the foreclosed-on property.

(EPA, p. 18377)

In general, a foreclosing holder must seek to sell or otherwise divest itself or (sic) foreclosed-on property in a reasonably expeditious manner using whatever commercially reasonable means are available or appropriate, taking all facts and circumstances into account. A holder cannot, consistent with the exemption, reject or refuse offers for the property that represent fair consideration for the asset. A holder that outbids or refuses offers from parties offering fair consideration for the property establishes that property is no longer being held primarily to protect a security interest.[1] The terms of the bid are relevant for this purpose, and a holder is not required to accept offers that would require it to breach duties owed to other holders, the borrower, or other persons with interests in the property that are owed a legal duty.

(EPA, p. 18378)

While a holder may use whatever means are reasonable and appropriate for marketing foreclosed-on property to establish that it is seeking to divest itself of property in an expeditious manner, this final rule also provides a mechanism by which a holder can definitely establish that it continues to hold indicia of ownership primarily to protect a security interest and is not an "owner or operator" of foreclosed-on property. This mechanism is intended to act as another "bright line" to provide clear and unambiguous evidence that a holder is not the facility's "owner or operator" following foreclosure: a holder choosing to avail itself of this bright line test must within twelve months following the acquisition of marketable title, list the property with a broker, dealer, or agent who deals with the type of property in question, or advertise the property as being for sale or disposition on at least a monthly basis in either a real estate publication or a trade or other publication suitable for the property in question, or a newspaper of general circulation (defined as one with a circulation over 10,000 or one suitable under any applicable federal, state, or local rules of court for publication required by court order or rules of civil procedure) covering the area where the property is located. If the holder satisfies these criteria, the holder is considered to have complied with the requirement that it is seeking to sell or otherwise divest the property in an expeditious manner.

(EPA, p. 18378)

Precisely because a holder in charge of a facility may need to take affirmative action with respect to the facility incident to foreclosure and with respect to any hazardous substances that are known to be present, the rule provides that such actions of dominion and control over the facility are considered necessary components of holding ownership indicia primarily to protect a security interest.

(EPA, p. 18379)

In addition to these EPA rules, many states have recently attempted to define or delimit the environmental liability of lenders to reduce their risk exposure in this area, but significant uncertainty and vulnerability still remains. Clearly, the courts and federal and state agencies will comment further on this issue, and lenders should monitor such decisions to assess changes in their environmental liability status.

The Environmental Audit

Because of the liability risk, an environmental audit should be completed prior to loan closing for any agricultural real estate or facility loan. The complexity of the audit depends upon the potential of an environmental problem. A Phase I audit involves three basic steps: (1) a review of public records for any potential environmental problem, (2) a site evaluation questionnaire, and (3) a site inspection. The types of information that should be obtained in the Phase I review process include answers to the following questions:

(1) If there is an active well on the property, where is it located with respect to fuel tanks, livestock facilities, etc., and has it been tested for water quality?

(2) Are there any abandoned wells on the property? If so, have they been used as a waste disposal site or have they been capped?

(3) If the property includes livestock facilities, what has been and is the animal waste disposal method used; how close are the facilities to streams or waterways, towns, and other personal residences; and have proper state and federal permits for construction and waste disposal been obtained?

(4) Has there been any potentially hazardous construction material such as asbestos, foam insulation, or lead-based paint used in the construction of any of the buildings or facilities on the property?

(5) Are there any disposal sites for empty chemical containers on the property and, if so, where are they located with respect to wells and waterways; what chemicals are included in the site; and what are the soil characteristics underlying the disposal site?

(6) Are there any known or suspected spills or other dumping of chemicals, petroleum products or hazardous or toxic materials on the property and, if so, what cleanup or containment and disposal methods were used?

(7) Are there storage facilities for chemicals such as fertilizer and pesticides on the property and, if so, what is the condition of these facilities, location with respect to water supplies and protection and containment structures in case of leakage or accidental spills?

(8) What facilities are used to store fuel or petroleum products; what is the location of these facilities vis-a-vis water supplies; and what protections are used to contain and prevent damage from leaks and accidental spills?

(9) Are there or have there been any underground storage tanks for fuel or other chemicals on the property; if so, have they been removed or inspected; are there or have there been any known or suspected leaks; and what cleanup procedures were used?

(10) Has part of the property ever been used as a site for production, formulation, distribution or storage of agricultural chemicals such as herbicides, fertilizer, pesticides or petroleum; if so, how were the facilities removed and the site cleaned up and were there any known or suspected spills or other contamination from this site?

(11) Has industrial waste or municipal sludge ever been used as fertilizer on the farm or has any part of the property ever been used as a waste disposal site, municipal dump, or landfill; if so, what disposal techniques and procedures were used, were proper permits obtained, and what is the location of these sites with respect to ground- and surfacewater sources?

(12) Is the property in compliance with all federal and state rules and regulations with respect to soil erosion and runoff, conservation practices, and CRP land management practices, tiling and conversion of wetlands, etc., and, if not, what procedures are necessary to obtain compliance and what will be the cost?

A Phase I environmental audit could be included as a standard component of the loan review and documentation process as completed by the loan officer, or it might be part of an appraisal report completed by an environmental consultant.

If the Phase I review uncovers a potential environmental problem, a Phase II audit should be initiated. This audit must be completed by a qualified environmental consultant and include scientific sampling and testing of air, soil, water, construction materials, engineering design, and any other relevant physical properties of the subject property.

Because the Phase II analysis is triggered by the existence of a potential problem identified in Phase I, it is essential that the Phase II analysis be done by a qualified professional to meet any "due diligence" test if litigation should occur. If the Phase II analysis identifies an en-

(more on page 22)

vironmental problem, then the lender can deny the loan request, or approve the request based on the condition that the environmental problem is corrected and the "cleaned-up" property will pass a subsequent environmental audit.

Collateral and Foreclosure

The discussion thus far would suggest that although certain collateral may be valuable to reduce credit risk in case of default, it may carry with it the risk of environmental liability.

Vulnerable collateral would include such properties as "suspect" real estate where there is any evidence from a site inspection, public records, or other information that an environmental problem exists; livestock facilities that do not comply with county or state regulations concerning waste disposal and storage or have other potential environmental problems including the potential of air or water pollution; any potentially contaminated property including that suspected of chemical spills, or where asbestos or other hazardous materials were used in construction; and any chemical or fertilizer storage, transportation, or application facilities and equipment.

To protect against environmental liability upon foreclosure, the lender should conduct a second audit to determine if environmental problems have occurred subsequent to the first audit completed at loan closing. Furthermore, as suggested by the EPA regulations, the lender should avoid any actions which can be interpretable as "managing" the property. In fact, the lender should possibly consider abandonment as an alternative to foreclosure if environmental problems are severe. In spite of EPA rules and court decisions to the contrary, the lender is most likely to be a defendant in any liability law suit and at minimum will incur the cost of that defense.

Reduce Environmental Risk

Although it is impossible to completely eliminate the risk and cost associated with environmental compliance and liability, it can be reduced or mitigated by using some basic management practices in the loan review and monitoring process.

The first requirement is to complete a written environmental audit prior to loan closing and include it as part of the loan documentation. This procedure should provide evidence of the "due diligence" activities of the lender if litigation should occur.

A second step is to exclude any vulnerable assets as collateral for the loan. If the purpose of the loan is to buy a piece of real estate or construct livestock facilities, an environmental audit should indicate whether these assets are "vulnerable" or not. In some cases, it may be desirable to advance loan funds for one purpose (for example, construct a new hog confinement facility), but the collateral or security for the loan might be other assets such as "clean" real estate not associated with the facility. Although such cross-collateralization may be difficult, it is one way to minimize potential environmental liability or clean-up costs if foreclosure occurs.

A third procedure to reduce environmental risk is to request written warranties and/or indemnification from the borrower in the event environmental problems occur and costs must be incurred. Although yet undeveloped in rural real estate markets, there may be opportunities to acquire environmental insurance in the future much like one acquires title insurance or other liability insurance. And, certainly, the lender should receive a commitment from the borrower that if there is any violation of environmental rules or regulations, the lender will be notified.

Risks and Costs

The cost associated with environmental compliance and liability can be substantial. First is the Phase I environmental audit including site inspection. The direct cost of the Phase I audit depends upon whether the lender uses external resources or its own personnel to complete the process, but such an audit may cost up to $2,500 of loan officer or environmental consultant time to complete. A Phase II environmental audit that involves engineering tests and more detailed site inspections can cost from $2,000 to $10,000 and possibly more for a sizeable agricultural real estate or livestock facility loan.

Second, if a lender uncovers an environmental problem on property it has taken through foreclosure or other procedures, it is most likely going to be responsible for the cost of any clean-up activities. Certainly, the lender would have a claim against prior owners of the property or others responsible for the environmental problem, but such claims most likely will require litigation to enforce. And, in addition to the clean-up costs, lenders have on some occasions found that the property has zero value and so the only logical course of action is abandonment. Note the high cost of taking environmentally vulnerable property in foreclosure – it is very painful to incur thousands of dollars of clean up cost and then have to abandon the property.

A final potential cost is the liability for environmental damages to third parties; this cost can be substantial and is more commonplace under environmental law than is the case with most business transactions.

Conclusion

The environmental risk in agricultural lending may be much greater than the credit risk for many loans. This is the case because environmental damages may be large (particularly third-party damages), the law and courts provide only limited protection for the lender in liability suits, and the collateral securing the loan frequently loses substantial value if an environmental problem is uncovered. Thus, environmental rules and regulations are important in agricultural lending, and the potential costs and risks of not complying with these rules are high.

An environmental audit is an essential component of the loan review and documentation process, and other procedures including indemnification clauses and refusal to accept vulnerable property as collateral should be considered as part of the loan decision.

Compared to the credit risk associated with many agricultural loans, the environmental risk and subsequent cost and losses may be very high, even for the most creditworthy borrowers. ▲

[1]To the extent that the foreclosing lender is acting "primarily to protect its security interest" and is within the secured creditor exemption. EPA considers that the ownership of the property remains with the borrower for purposes of the CERCLA lien provision.

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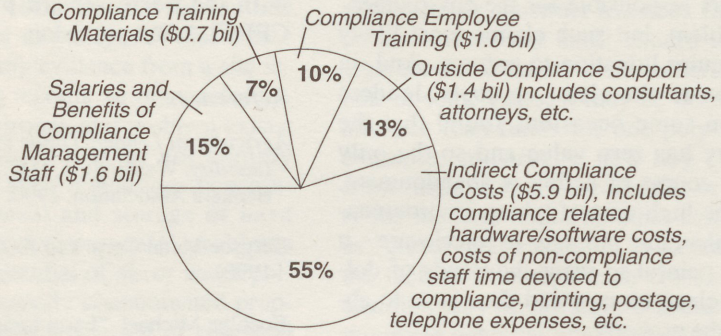
Survey of Regulatory Burden

ABA's Office of the Chief Economist conducted a survey to assess the burden of bank regulation. You'll find two of the key findings outlined below.

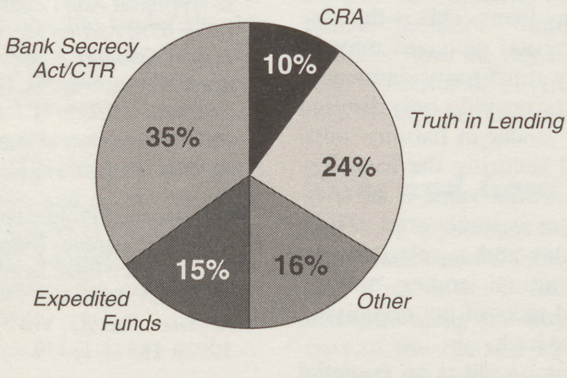
Total Industry Compliance Cost is an Estimated $10.7 Billion Annually



Non-Compliance Staff Bear the Brunt of Many Regulatory Burdens

Tellers and Loan Officers are Among Those Most Affected

Percent of Respondents Citing the Regulation as the Most Burdensome to Non-Compliance Staff



More than 1,000 bankers replied. The full results of the survey will be outlined in the next issue of the ***Journal.*** *For more information on the findings of this landmark survey, call Jim Chessen, ABA's Chief Economist at 202-663-5354.*