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Potential Lender Liability for Environmentally Hazardous Collateral

A recent Ohio appellate court decision could have lasting implications for lenders that take possession of potentially hazardous collateral upon the borrower's default. In *State v. Roberts* (2010-Ohio-2003), the Court of Appeals for the 6th District of Ohio reversed a grant of summary judgment in favor of a lender that denied responsibility for the impact of its defaulting borrower's environmentally hazardous collateral. Future courts may possibly interpret this opinion to mean that R.C. 1309.610 imposes an affirmative duty on lenders to dispose of collateral in their possession in a commercially reasonable manner. The *Roberts* decision moves Ohio courts one step closer to accepting the "instrumentality" theory of liability, under which lenders assume liability if they exert significant control over the day-to-day business of their debtors. If adopted, the combination of an affirmative duty for commercially reasonable disposal, along with instrumentality liability, would result in an Ohio law that mirrors the lender liability exemption under the federal Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA"). Once a lender takes possession of collateral upon a borrower's default, the lender should proceed with caution to ensure the collateral's compliance with all laws and regulations until final disposition.

In *Roberts*, Citizens National Bank of Norwalk ("Citizens") extended credit to Ultimate Industries, Inc. ("Ultimate"), whose manufacturing business involved the use of various chemicals and generated hazardous waste. As security for the loan, Ultimate granted a mortgage and various other security interests to Citizens on Ultimate's real property and other assets, including over fifty 55-gallon drums of chemicals. When Ultimate eventually defaulted on its obligations, Citizens took possession of the property and began exercising its remedies, including foreclosing on the real property and liquidating the chemicals and other collateral with a resale value. The Ohio Attorney General soon filed a complaint against Ultimate for injunctive relief and civil penalties, claiming that some of the chemicals stored in the 55-gallon drums had become unusable and hazardous during the time in which Citizens had possession of the property. Ultimate argued that Citizens had a duty to ensure the chemicals did not become hazardous, as it had possession of the property.

The trial court granted Citizens' motion for summary judgment, agreeing that Citizens had no contractual duty to remediate, respond to, or clean up hazardous waste at the premises. The court of appeals reversed, finding that a question of fact existed as to whether Citizens breached its duty under R.C. 1309.610 by failing to dispose of the collateral in a commercially reasonable manner. Specifically, the court posited that although R.C. 1309.610 did not unilaterally impose a duty on a secured creditor to assume responsibility for potentially hazardous waste, if Citizens took possession of the collateral and proceeded to dispose of some of it, it may have triggered the requirement that "every aspect of the disposition of collateral, including the method, manner, time, place and other terms, must be commercially reasonable." It is unclear from the opinion whether the court thought that it was Citizens' security interest, its possible possession of the property, or its sale of some of the 55-gallon drums that may have triggered the duty to dispose in a commercially reasonable manner. The decision stated that questions of fact remained regarding whether Citizens had possession of all the inventory, knew the drums of chemicals were marketable, and failed to dispose of the chemicals in a commercially reasonable manner.

The court's potential finding of an affirmative duty under R.C. 1309.610 may lead to expansion in other areas of Ohio lender liability law. Some other states have adopted an "instrumentality" theory of liability, for which a lender is liable for the acts and omissions of its borrower under certain circumstances. In states that recognize instrumentality liability, the following elements are necessary for the doctrine to apply: (1) the lender must have total domination over the borrower, to the extent that the borrower manifests no separate interests of its own and functions solely to achieve the purposes of the lender, and (2) a misuse of this control by the lender must proximately result in fraud or injustice. (*Thayer v. Diver*, 2009-Ohio-2053). Ohio courts have not yet imposed instrumentality liability, but they have been willing to consider the facts of individual cases against the elements mentioned above. *Roberts'* potential imposition of affirmative duties for lenders under R.C. 1309.610 would indicate Ohio courts' willingness to expand lender liability, possibly including adoption of the instrumentality liability doctrine as well.

If Ohio courts were to adopt both the instrumentality theory of liability and an affirmative duty of commercially reasonable disposal of collateral, it would bring Ohio lender liability law more in line with federal CERCLA law. CERCLA has a lender liability provision exempting from liability any "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. § 9601(20)(A)). If a lender forecloses on a property, it can avoid liability if it maintains business activities; winds up operations; undertakes a response action under CERCLA § 107(d)(1) or under the direction of an on-scene coordinator; sells, re-leases or liquidates the facility; or takes actions to preserve, protect, or prepare the property for sale. A lender may do any of the above and remain exempt from liability as long as the lender tries to sell or re-lease the property or otherwise divest itself of the property at the earliest practicable, commercially reasonable time using commercially reasonable means. If Ohio imposes the dual requirements of instrumentality liability and an affirmative duty for commercially reasonable disposal, the result would be very similar to the scope of CERCLA's lender liability.

Although the *Roberts* ruling was but a first step in the final determination of Citizens' environmental liability, it could have implications well beyond this specific context. In short, it could establish a precedent that lenders that take possession of collateral under R.C. 1309.610 could be liable for damages to the borrower, or third parties, resulting from the lender's failure to maintain and dispose of that collateral in a commercially reasonable manner. Lenders should, therefore, be cautious when exercising their remedies as a secured party, particularly when taking complete control and possession of the collateral in anticipation of a public or private sale.