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# LENDERS AND RISKY ACTIVITIES: STRICT LIABILITY OR NEGLIGENCE RULE?

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GÉRARD MONDELLO

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# LENDERS AND RISKY ACTIVITIES: STRICT LIABILITY OR NEGLIGENCE RULE?

G rard Mondello\*

*GREDEG Working Paper No. 2017-13*

**Abstract:** *The amendments made to CERCLA in 1996 reinforced the exemption of lenders that finance ultra-hazardous activities. Then, they become involved in liability only if they manage or own polluting activities. The paper compares strict liability and negligence rule in an agency model of vicarious liability type, and proposes to restore lenders as principal by applying negligence rules to them while operators would resort to a strict liability rule. This scheme leads the lender to propose to the borrower the most favorable loan level that induces the latter to provide the socially optimal security level.*

**Keywords:** Strict liability, negligence rule, moral hazard, judgment-proof, lenders, risky activities.

**JEL:** K0, K32, Q01, Q58.

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## 0. Introduction

Under rising environmental distress, public opinion deems that banks, factoring institutions, and lenders who finance ultra-hazardous activities carry some significant responsibility for harm to Health and Environment. This point of view reinforced after the adoption of the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) in 1980 in the United States and some significant cases law that followed. Then, for almost fifteen years, the Courts involved the institutional lenders' responsibility. Implicitly, the Environmental Protection Agency (EPA) was seeking out creditworthy institutions to finance environmental clean-up costs as substitutes for impecunious and defaulting operators. Simultaneously, scholars began to theorize the necessary involvement of lenders (Summers 1983, Shavell 1986).

Reviewing closely this jurisprudence shows that, mostly the courts penalized lenders not for their responsibility as lenders but because of their involvement as owners or for day-to-day management of the facilities. Indeed, initially, CERCLA did not accurately distinguish between these three activities. However, since 1996, corrective amendments exempt lenders from any responsibility if they limit their involvement at securing their loan<sup>1</sup>. Consequently, now, CERCLA harshly differentiates between lending activities and management and/or ownership activities. Thus, the lenders can escape responsibility even if their loan contributes at increasing the pollution scale<sup>2</sup>. Moral and legal responsibilities belong to different worlds<sup>3</sup>.

Legitimately, the early ante 1996 CERCLA jurisprudence deeply influenced economic theory (see Boyer and Laffont 1995), (Boyer and Laffont 1997) and (Pitchford 1995) among others). However, the recent economic analysis seems underestimating the consequences of the 1996 amendments for economic theory (Hiriart and Martimort 2006), (Dionne and Spaeter 2003), (Boyer and Porrini 2009) for instance. Consequently, whatever their solutions' relevancy, the legal framework rigidity and stickiness make them ineffective.

Hence, this paper analyzes how restoring bridges between academic views and legal practices, despite the 1996 amendments. Particularly, it insists on the opportunity to extend negligence to lending activities rather than confining it to both the owning or the direct managing of hazardous facilities. For this purpose, within an agency relationship where bank and borrower face, we compare two responsibility regimes: strict liability and negligence. This type of analysis is typically vicarious liability i.e. the liability of one party, generally the 'principal' for the wrongdoing of another party, the 'agent' (here the operator)<sup>4</sup>. Newman and Wright (1990) show that in the presence of moral hazard, strict liability induces the principal to offer a contract which gives rise to a socially optimal level of care. For Demougin and Fluet (1999) when the agent earns a positive rent, strict liability generates an under-provision of safety while negligence rule leads to optimality. Boyer and Laffont (1997)<sup>5</sup> studied the

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<sup>1</sup> "SEC. 2502. CERCLA Lender and fiduciary liability limitations amendments.

<sup>2</sup> See for instance, (Lee and Egede 2005).

<sup>3</sup> See the exhaustive study of the (Global Legal Group 2010) or still (OECD 2009).

<sup>4</sup> In this field, the roots of the analysis are offered by the works of Sykes (1984), Sykes (1988) and Sykes (1998). We refer equally to (Kornhauser 1982) or (Polinsky and Shavell 1993), Schmitz (2000), (Dari-Mattiacci, and Parisi 2003), and (Dari-Mattiacci 2006). We can also mention (Segerson and Tietenberg 1992) and (Menell 1991). For a global analysis see also (Larsson 1999).

<sup>5</sup> The literature dedicated to the liability of the lender is currently quite significant. The leading contributions have been supplied by (Pitchford 1995), (Boyer and Laffont 1995), (Boyer and Laffont 1997), (Gobert C. Poitevin 1998), (Balkenborg 2001), (Hiriart and Martimort 2006), (Heyes 1996), (Fees 1999), and (Boyer and Porrini 2006).

involvement of banks in cases of environmental damage: “*Liability of the bank is not a sufficient instrument to reach the second best allocation when rents must be given up either to induce effort or to induce the truthful revelation of profit levels*” and they call to a more stringent liability. Following them, strict liability induces lenders to abandon highly risky projects. Hence, a second-best level of efficiency entails enforcing a kind of partial liability. This paper is an attempt to clarify this point. Consequently, applying negligence to banks would induce them keeping on lending to risky sectors, because they can exert careful control on the potential polluter.

The first part of this paper analyzes the differences between CERCLA pre- and post-1996 amendments. A second part develops a model based on asymmetric information. It presents how to involve the lenders’ liability without discouraging him from financing the risky activities. The model presents a contractual relationship between a principal (the lender) and an agent (the borrower that develops the risky activity). Hence, when the Courts adopts the regulator’s standard care level, then the ex-ante contract that binds together principal and agent leads the last one to supply the socially first-best level of care. This is no longer the case when the court and the regulator diverge about it. Furthermore, the paper shows that a negligence rule regime applied to lenders for lending is better than strict liability that discourages the lending effort. Consequently, comparing negligence and no-responsibility for lenders, as it is nowadays the case cannot be done on simple efficiency criteria. Justice among wrongdoers and the necessity for the regulator to dispose of more regulatory instruments pleads for enforcing negligence on lenders. A third part discusses the results and concludes.

## **1. Lenders liable for lending, not for managing or owning**

Under CERCLA, generally, when EPA discovers brownfields, it must have them cleaned at the injurer’s expense. Alternatively, if the polluters are unknown, it must identify responsible owners and operators and oblige them paying back the incurred costs. Originally, however, CERCLA did not clearly define the field of lenders’ liability<sup>6</sup>. This weakness opened the door to divergent law cases about lenders’ involvement.

### ***CERCLA before 1996***

At its beginning, CERCLA did not involve lenders in liability. Indeed, a responsible person should have exercised operational management and/or ownership (Burke 1998). Nevertheless, CERCLA enacted a safe harbor provision for lenders, the Security Interest Exemption (SIE), which prevented naming them as operators. This “*does not include a person who, without participating in the management of a facility, holds indicia of ownership<sup>7</sup> primarily to protect his security interest in the facility*”<sup>8</sup>. Consequently, the lenders who owned a foreclosure on a mortgaged property considered themselves free from liability. However, courts narrowed the frontiers between the activities of securing loans (i.e. monitoring facility performance, conducting environmental inquiries and consulting, demanding clean-up of the site) and the control activities. Therefore, sometimes, they saw the lenders as owners or operational operators and excluded them from the SIE field, and sometimes not. To illustrate the point, we review some well-known principal case law.

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<sup>6</sup> See for instance (Greenberg and Shaw 1992).

<sup>7</sup> “Indicia of ownership” corresponds to evidence of interests in real or personal property and includes a mortgage, a security bond, legal or equitable title, etc.

<sup>8</sup> See for instance (Larsson 1999), (Ahrens and Langer 2008).

First, under the “United States v. Mirabile” case<sup>9</sup>, the EPA had to recover its response costs for the decontamination of a site owned by Mr. and Mrs. Mirabile (Turco Inc.). These one claimed that the lenders (Mellon Banks, American Bank and Trust Company) were binding parties in the recovery process because they lent money and held a mortgage on the facility. The Court considered that one among the three (Mellon) did not fall under SIE protection. Indeed, Mellon provided working capital and behaved as a day-to-day manager. The other banks did not exert any ownership or management and only secured their loans.

A second famous case is “United States v. Maryland Bank & Trust Co”<sup>10</sup>. This bank took a mortgage on a facility that owned a field that collected hazardous waste. The facility went bankrupt and the bank purchased the land at the foreclosure in 1982. The EPA discovered contamination and removed it and, then, sued Maryland Bank for recovering its cleaning-up costs. The Court imposed liability on this bank because it possessed the land for four years after the foreclosure sale. Indeed, the court held that as bank, it could develop sufficient expertise to make strategic financial choices with full knowledge: *“financial institutions are in a position to investigate and discover potential problems in their secured properties. CERCLA will not absolve them from responsibility for their mistakes of judgment”*<sup>11</sup>.

In the case United States v. MC Lamb, O. Skipper and Wachovia Bank and Trust Company<sup>12</sup>, the EPA discovered and cleaned-up a polluted area. The agency sued the new owners (Wachovia Bank). A district court granted judgment in Wachovia’s favor on the appellants’ CERCLA claim. The Courts (district court and appellate court) claimed that the bank fell under the SIE exemption. Indeed, there was no indication that Wachovia had knowledge of the contamination prior to taking a security interest. Wachovia purchased the property *“primarily to protect its security interest”* after Skipper's default. The record discovered no investment or profit motive for acquiring the property.

Another precedent tended to follow the restrictive interpretation of the Maryland Bank & Trust Co (“Guidice v. BFG Electroplating and Manufacturing Company, Inc.”<sup>13</sup>) for consideration of ownership after disclosure. Considering “United States v. Nicolet, Inc.”<sup>14</sup>, the judge put forward that the lender (T & N Public Limited Company) held a mortgage and actively managed the facility. Hence, the CERCLA jurisprudence in the early 90’s tended to narrow the lenders’ exemption field. This went on until the Fleet Factor case<sup>15</sup> that the banking profession considered as a potential non-return situation. The banking industry reacted firmly and induced lawmakers to bring about changes to the conception of lender’s liability in CERCLA.

Fleet Factors Corporation was a factoring company. Since 1976, it advanced funds to its client Swainsboro Print Works (SPW). Fleet got a security interest in SPW which nevertheless went bankrupt in 1979. In 1981 Fleet ceased its financing and, in May 1982, foreclosed on its SPW security interest. It contracted with Baldwin Industrial Liquidators to conduct an auction on the collateral with Nix Riggers (“Nix”). The purpose was removing the unsold equipment. Nix left the facility by the end of December 1983. In January 1984, EPA inspected the location and found high chemical and asbestos contamination. The EPA incurred cleanup costs of nearly \$400,000. To recover these costs, EPA sued SPW’s main

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<sup>9</sup> N°. 84-2280, 15 ELR 20994 (E.D. Pa; Sept. 4, 1985)

<sup>10</sup> 632 F. Supp. 573 (D. Md. 1986).

<sup>11</sup> *Id.* at 580.

<sup>12</sup> 5 62 USLW 2189, 23 Env'tl. L. Rep. 21,500, F.3d 69.

<sup>13</sup> 732 F. Supp. 556 (W.D. Pa. 1989).

<sup>14</sup> 712 F. Supp. 1193 (E.D. Pa. 1989).

<sup>15</sup> *Fleet Factors Corp.*, 901 F. 2d at 1550.

stockholders and Fleet Factors Corp. The judgment showed numerous evidence that Fleet Corporation had exerted operational management (i.e. defining the price policy, firing employees, negotiating contracts with Nix and Baldwin, etc.). All these facts were sufficient by themselves to exclude Fleet from the SIE exemption. In spite of them, the Court drastically changed the CERCLA philosophy. Indeed, the judge determined the lender's liability on the foundation of its lending activity and its associated position on the facility's management:

*“It is not necessary for the secured creditor actually to involve itself in the day-to-day operations of the facility in order to be liable (.). Nor is it necessary for the secured creditor to participate in management decisions relating to hazardous waste. Rather, 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. See, No. 84-2280, slip op. at 4.”*

If duly extended, without modifying the Law this jurisprudence would have become commonplace and changed the whole policy of the financing system. Hence, the banks considered that CERCLA jurisprudence was burdening them with an unbearable level of responsibility (Greenberg and Shaw 1992). Consequently, they threatened to restrict their involvement in environmental risky projects (Burke 1998, p. 16 notes) and, obviously, this could "kill the investment" (Boyer and Laffont 1997).

#### ***After the “Fleet factor case”: the 1996 amendments***

Institutional lenders indulged in active lobbying and contributed to the adoption of the “Asset Conservation, Lender Liability, and Deposit Insurance Protection Act” (or the 1996 Amendments). This act narrows the liability of financial institutions because it reinforces the secured creditor exemptions of CERCLA. Since 1996, lenders are no longer considered as owners or operators except if, explicitly, they do exert this function. This involves the definition of permissible activities that can be conducted without exceeding the bounds of exemption. Hence, the differences about the meaning of “participating in the management” before and after the 1966 Act must be clearly stated. Precisely, since 1996 the EPA's rule is codified in 42 USC 9601(20)(E) entitled “Exclusion of Lenders Not Participants in Management”. Thus, entities that hold “indicia of ownership” primarily to protect their security interest in the vessel or facility are not considered as owner or operator in the management of a vessel or a facility. A lender is any person who makes a bona fide extension of credit to acquire a security interest from a non-affiliated person.

The distinction between managing and not managing is subtle (Wright 2000). “*Participation in Management*” means taking part in the management or operational affairs. Expressly, it does not include the fact of having merely the capacity influencing or having the unexercised right to control the facility operations. Liability exception applies if lenders foreclose and then sell, re-lease, liquidate the facilities, keep up business activities, wind up operations, undertake a response action, or take any other measure to preserve, protect, or prepare a site for sale or other disposition. In all cases, the lender falls under the SIE clause if he seeks to do these things, “at the earliest practicable, commercially reasonable time, on commercially reasonable terms.”<sup>16</sup>. These amendments contradict the previous jurisprudence and mean that lenders are deemed to be liable anytime they exercise an effective control of the facility (handling or disposal of hazardous substances, day-to-day management, etc). This prevents the will of fiduciaries to exert any control and take an effective part in the management of the potentially risky industry. An agent will be liable if the Court shows that

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<sup>16</sup> 42 U.S.C. §9601(20)(E), Cited by Sigel and Cane (2007 p.4)

he exercised an operational activity. Legally, the lender can no longer be regarded as an operator or an owner even for disclosure operations.

Section 101(20) of CERCLA contains the secured creditors exemption that restricts their liability provided they do not “participate in the management of the facility”. Paradoxically, the text defines “participate in the management” by explaining how a lender does not contribute in it. Mainly, a financier cannot be suspected as having managed the facility if he proves that he did not exert any operational activity. This corresponds to exercising decisions, making control, supervising as a manager or, still, operational functions without links with environmental compliance.

Oddly enough, these factors do not prevent lenders from playing an active role in facility management provided that they bring the proof that they secured their loan. Hence, besides certain financial operations (restructuring, holding or abandoning a security interest, taking mortgage or warrant, etc.), the lender can undertake any action to stop or slow down the “release or threatened release of a hazardous substance in connection with the vessel or facility prior to, during, or on the expiration of the term of the extension of credit”. The lender can also “*provide (ing) financial or other advice or counseling in an effort to mitigate, prevent, or cure default or diminution in the value of the vessel or facility*” (section F), and can monitor the facility under the condition of not increasing its level of participation.

In summary, CERCLA does not prevent lenders from participating in facility management as long as this supervision aims at securing their loans. Hence, lenders can exert an indirect influence on the long-term management of the facility by providing financial or other advice and counsel, restructuring the credit, rendering care in accordance with the National Contingency Plan (section 9607 (d)) without incurring the risk of a liability involvement.

By restricting the meaning of the notion of “participation in management”, the 1996 amendments made the involvement of lenders and insurers particularly difficult. Too demanding banks can be considered as day-to-day operators. Hence, banks are deterred from exercising any control over a facility at a level similar to that of an operator. However, this does not preclude lenders from carrying out thorough checks before granting a loan while remaining within the provision of the safe harbor. Furthermore, they can prevent default or the diminution of the value of the collateral or impose financial workout requirements, etc.

In 2002, the above restrictive tendency increased with the adoption of the “Small Business Liability Relief and Brownfields Revitalization Act” (the Brownfields Amendments) that limits still further the retrospective liability of owners and operators. Consequently, going beyond the legal safety requirements is legally risky. Under CERCLA, strict liability applies to owners, operators, and negligence rule to lenders (Feess 1999). After a pollution occurrence, the banks have to prove that their actions remained within the exemption field area. Hence, it is particularly difficult to establish a causal link between the harm and the loan, except to say that, without said loan, the scale of the damage would have been of lesser magnitude. As a consequence, the lenders do not seriously check the borrowers’ compliance to safety rules when, by law, their action is limited to securing their loans. This situation is inefficient because, as principal, the lenders cannot play an active role. Contrary to what literature says, nowadays the banks are imperfect principals. They cannot be regarded as principals in the same way as a legal regulator (the State, for instance, or regulatory agency). This point will be analyzed through the following model.

## 2. The Model

This model studies the relationships between a regulator, a lender (he), an operator-borrower (she) and a court. The operator borrows funds from the lender for financing their ultra-hazardous activities. She possesses no initial wealth. The regulator enforces a given liability regime and the court estimates the tortfeasor's liability after an accident occurrence. It is a unilateral accident situation i.e. the potential victims have no own care technology that influences the expected harm. The operator is potentially solely responsible for any accident.

### 2.1 Notations and assumptions:

- The indexes "SL" and "NR", respectively, stand for "Strict Liability" and "Negligence Rule", while the indexes "P" and "A" point out respectively the "Principal" and the "Agent".
- The operator (the Agent) borrows the amount  $t$  from the lender (the Principal) and she spends  $x$  to guard against the risks of accident:  $t \geq x \geq 0$ , hence,  $t - x \geq 0$  is used for productive activities.  $G(t, x)$  is an increasing function of  $t$  but a decreasing function of  $x$ . For a borrowed amount  $t$ , she expects a net receipt  $G(t, x) \geq 0$ , (with  $G'_t(t, x) > 0$ ,  $G'_x(t, x) \leq 0$ ,  $G''_{xx}(t, x) \leq 0$ ,  $G''_{tt}(t, x) \leq 0$ ).
- Under a normal state of affairs (no accident) the expected wealth of the principal is  $W_p$  plus the expected gains from the lending to the agent  $R(t)$  (where  $R(t) \geq 0$ ). The functions  $G(t, x)$  and  $R(t)$  will be more precisely defined below.
- The occurrence of  $D$  corresponds to the damage costs due to a major hazard.
- **Assumption 1:** The principal and the agent are risk-neutral.
- **Assumption 2:** The study focuses for the values of  $t \in T, T \subset \mathbb{R}$ , such that  $G(t, x) < D$ , (the borrower is judgment-proof).
- **Assumption 3:** The lender's wealth  $W_p$  can cover the damage  $D$ , i.e.  $W_p > D$  and he is never judgment proof for  $D$ , (hence  $D > t$ ).
- **Assumption 4:** Let  $\pi(x)$  be the probability of a major accident. This one diminishes as the safety effort increases, then,  $(1 \geq \pi(x) \geq 0, \pi'(x) < 0$  and  $\pi''(x) \geq 0)$ .
- **Assumption 5:** The borrower is subject to strict liability.

Theoretically, the regulator chooses one responsibility regime among several possible and enforces it. The model compares the following situation:

- A strict liability regime applied on both borrower and lender and,
- A negligence rule associated to the lending act while the borrower answers to strict liability (Assumption 5).

To deal with the question, we develop a general asymmetric information model that compares the mentioned situations. The lender does not know the borrower's true nature and this is source of asymmetric information. This typically adverse selection case induces the lender defining a contractual relationship between him and the borrower. The purpose is to prompt her supplying an optimal care level and deterring inefficient borrowers.

### 2.2 Asymmetric information, general framework

The model background is vicarious liability. Then, when potentially involved in liability because of his lending activity, the lender has to induce the borrower supplying the socially first-best care level. However, the lender exerts only a partial control because he can only determine the loan amount but not the borrower's its efficient use. The lender's first task is forming an ex-ante contract that determines both the optimal loan and the expected first-best care level. Under this background, the lender can escape to any liability and lets the borrower bearing the burden of responsibility if he succeeds by shaping and enforcing an

optimal contract. In spite of the fact that, implicitly this model is based on negligence, it gives sufficient foundations for extending it to strict liability and allowing comparisons.

**a) Timing of the game**

The game timing is threshold. 1) The principal decides on the amount ( $t^*$ ) he is willing to lend to the agent, conditioning it to a care level ( $x^*$ ). 2) The agent decides if she agrees with the proposition. Since she has no wealth of her own, she divides the loan between prevention ( $x$ ) and ( $t - x \geq 0$ ) as productive investment. 3) Nature decides whether an accident occurs with probability  $\pi(x)$  or not.

**b) The borrower's payoff function**

As simplification the borrower's payoff function is assumed linear in terms of the loan  $t$  and the safety amount  $x$  :

$$(1) G(t, x) = \beta t - \gamma t - \sigma t - x$$

Where,  $\beta t$  is the gross receipt ( $\beta > 1$ ),  $\gamma t$  is the share of  $t$  let to acquire inputs ( $\gamma \leq 1$ ),  $\sigma t$  is the whole loan charge (the amount of the loan plus the set of financial charges and interest) ( $\sigma > 1$ ), ( $\beta, \gamma, \sigma$ ) are parameters. Note that  $R(t)$ , the above interest charge corresponds to  $\sigma t$ , ( $R(t) = \sigma t$ ). As,  $\beta > \sigma > 1$  and  $t = \gamma t + x$ . This last expression means the loan is used to pay both the production costs  $\gamma t$ , and the safety costs  $x$ , then:

$$(2) t = \frac{x}{1-\gamma}$$

Using (2),  $G(t, x)$  transforms as :

$$(3) G(t, x) = \beta t - \theta x \text{ where } \theta = \frac{1+\sigma}{(1-\gamma)}$$

The "cost" factor  $\theta$  is built from the financial cost  $\sigma$ , the production cost  $\gamma$  and the safety cost  $x$ . Hence, for given  $\beta$  and  $\sigma$ , the higher the cost input parameter  $\gamma$ , the higher  $\theta$  is.  $\theta$  corresponds to the borrower's financial capacity to comply with the lender's safety requirement. Indeed, given a  $\bar{t}$  loan level, considering two borrowers characterized by their costs where  $\gamma' > \gamma'' > 0$  ( $\Rightarrow \theta' > \theta''$ ), then,

$$\bar{t} = \frac{x'}{1-\gamma'} = \frac{x''}{1-\gamma''} \Rightarrow x' < x''$$

The  $\theta''$  type dedicates more means to protection than the  $\theta'$  one. Then, from (1), we write, the agent's expected payoff function as:

$$(4) EW_A = (1 - \pi(x)) + \pi(x) 0 = (1 - \pi(x))(\beta t - \theta x)$$

As by assumption the agent has no wealth, she uses all her revenues  $G(t, x)$  for repairs in case of an accident occurrence while she pays the amount due to the lender  $\sigma t$ .

**c) The lender's wealth function**

Under strict liability applied to the lenders, the repairs correspond to  $D - G(t, x)$  (i.e. the harm total costs minus the operator's gain used for repairs). Hence, the lender's expected wealth writes as:

$$(5) EW_P = (W_P - (D - G(t, x)) + \sigma t)\pi(x) + (W_P + \sigma t)(1 - \pi(x)) \\ = W_P + \sigma t + (G(t, x) - D)\pi(x)$$

And his expected wealth writes as:

$$(6) EW_P = \sigma t + W_P - \pi(x) (D - (\beta t - \theta x))$$

From (4) and (6) we deduce the social expected wealth function:

$$(7) EWS = EW_P + EW_A = \sigma t + W_P - \pi(x) (D - (\beta t - \theta x)) \\ + (1 - \pi(x))(\beta t - \theta x) = W_P - x \theta + \sigma \frac{x}{1-\gamma} - D\pi(x)$$

From the first order conditions and by (2) and (3) we infer the socially optimal level of care  $x^*$ :

$$(8) \quad \frac{\partial EWS}{\partial x}(x^*) = \left( \frac{\beta-1}{(1-\gamma)} \right) - D\pi'(x^*) = 0$$

Or, still:

$$(9) \quad \pi'(x^*) = \frac{1}{D} \left( \frac{\beta-1}{(1-\gamma)} \right), \text{ for } (x^* > 0).$$

This result is conform to the standard accident theory. That means that the socially optimal care should be  $x^*$ .

### 2.3 Contract Equilibrium and information rent

As the model implicit liability regime is based on fault, the principal's own interest is to comply with the regulator's requirement. The adverse selection model determines both the first-best care level and the first best level of loan. Under asymmetric information, can the principal induce the borrower to supply the socially first-best care level  $x^*$ ? The agent is all the more likely to comply with this requirement that she feels efficient. Efficiency means that the agent's marginal costs are lower than the inefficient agent. Here,  $\underline{\theta}$  corresponds to the efficient agent's marginal cost and  $\bar{\theta}$  the one of the inefficient one, with  $\underline{\theta} < \bar{\theta}$ . Indeed, from (3), we verify that  $\underline{\theta} < \bar{\theta} \Rightarrow \underline{\gamma} < \bar{\gamma}$ . The lender does not know whether he faces an efficient or an inefficient agent. Under complete information, the principal can induce a level of safety corresponding to the capabilities of each category of agent:

$$(10) \quad \pi'(\underline{x}^*) = \left( \frac{\beta-1}{(1-\underline{\gamma})} \right) \frac{1}{D}, \text{ for the efficient agent and,}$$

$$(11) \quad \pi'(\bar{x}^*) = \left( \frac{\beta-1}{(1-\bar{\gamma})} \right) \frac{1}{D}, \text{ for the ineffective one.}$$

Under symmetric information, informational rents are null. Consequently, if  $\underline{U}^*$  and  $\bar{U}^*$  represent these rents, then:

$$(12) \quad \underline{U}^* = \beta \underline{t}^* - \underline{\theta} \underline{x}^* = 0 \text{ (a) and } \bar{U}^* = \beta \bar{t}^* - \bar{\theta} \bar{x}^* = 0 \text{ (b).}$$

Under information asymmetry, information rents are positive and express as:

$$(13) \quad \underline{U} = (1 - \pi(\underline{x})) (\beta \underline{t} - \underline{\theta} \underline{x}) \text{ (a), and } \bar{U} = (1 - \pi(\bar{x})) (\beta \bar{t} - \bar{\theta} \bar{x}) \text{ (b)}$$

Consequently, the regulator cannot implement the complete information optimal contracts and he has to define incentive for that. To deal with the point, we inspire from Laffont-Martimort (2002)'s definition:

**Definition 1:** A menu of contracts  $\{(\underline{t}, \underline{x}), (\bar{t}, \bar{x})\}$  is incentive compatible when  $(\underline{t}, \underline{x})$  is weakly preferred to  $(\bar{t}, \bar{x})$  by agent  $\underline{\theta}$  and  $(\bar{t}, \bar{x})$  is weakly preferred to  $(\underline{t}, \underline{x})$  by the agent  $\bar{\theta}$ .

At this point, it is important to note that the lender cannot restrict the borrower by supplying an insufficient level of loan. Consequently, the following constraints must be respected:

$$(14) \quad \begin{cases} \left( (1 - \pi(\underline{x})) (\beta \underline{t} - \underline{\theta} \underline{x}) \geq 0 \text{ (a)} \right. \\ \left. (1 - \pi(\bar{x})) (\beta \bar{t} - \bar{\theta} \bar{x}) \geq 0 \text{ (b)} \right) \text{ , and,} \end{cases}$$

These constraints look like usual participation constraints. The difference comes from uncertainty expressed by  $\pi(\underline{x})$ . Taking into account the information rents, the expected participation constraints express as:

$$(15) \quad \begin{cases} \underline{U} = (1 - \pi(\underline{x})) (\beta \underline{t} - \underline{\theta} \underline{x}) \geq 0 \text{ (a)} \\ \bar{U} = (1 - \pi(\bar{x})) (\beta \bar{t} - \bar{\theta} \bar{x}) \geq 0 \text{ (b)}. \end{cases}$$

The allocations must satisfy the following expected incentive compatibility constraints:

$$(16) \quad \begin{cases} \left( (1 - \pi(\underline{x})) (\beta \underline{t} - \underline{\theta x}) \geq (1 - \pi(\bar{x})) (\beta \bar{t} - \underline{\theta \bar{x}}) \right) (a) \\ \left( (1 - \pi(\bar{x})) (\beta \bar{t} - \bar{\theta \bar{x}}) \geq (1 - \pi(\underline{x})) (\beta \underline{t} - \bar{\theta \underline{x}}) \right) (b) \end{cases}$$

Or still, in the information rents terms:

$$(17) \quad \begin{cases} \underline{U} \geq \bar{U} + (1 - \pi(\bar{x})) \Delta \theta \bar{x} \quad (a) \\ \bar{U} \geq \underline{U} - (1 - \pi(\underline{x})) \Delta \theta \underline{x} \quad (b) \end{cases}$$

(Where,  $\Delta \theta = \bar{\theta} - \underline{\theta}$ ).

Hence, a menu of contracts is incentive feasible when he fulfils both incentive (18) and participation (19) constraints. The implementability condition insures that the efficient agent supplies a higher level of care compared to the inefficient one. To see the point, consider the incentive compatibility constraints, then, it is sufficient to add (a) and (b) from (19):

$$(18) \quad \left( 1 - \pi(\underline{x}) \right) \underline{x} \geq \left( 1 - \pi(\bar{x}) \right) \bar{x}$$

From this expression the monotonicity condition ensues:

**Proposition 1:** *From the incentive compatibility constraint and the implementability condition  $\left( 1 - \pi(\underline{x}) \right) \underline{x} \geq \left( 1 - \pi(\bar{x}) \right) \bar{x}$ , it results that the level of safety supplied by the efficient agent is higher than the one offered by the inefficient agent. This is the monotonicity condition:  $\underline{x} \geq \bar{x}$ □*

**Proof:**

If  $\underline{x} < \bar{x}$ , then, as  $\pi(x)$  decreases,  $\pi(\underline{x}) > \pi(\bar{x})$  and obviously  $\left( 1 - \pi(\underline{x}) \right) < \left( 1 - \pi(\bar{x}) \right)$ , this contradicts the implementability condition. Consequently,  $\underline{x} \geq \bar{x}$ □

## 2.4 The lender's optimization program

The lender ignores the borrower's true nature. He has to define a contract set and induce her to supply the higher level of care keeping in mind that this level should correspond to the social first best. Designing the contract has to be done before knowing the agent's category. The lender's program writes then as:

$$(19) \quad \mathcal{L} \left( (\underline{t}, \underline{x}), (\bar{t}, \bar{x}) \right) = \text{Max}_{\{(\underline{t}, \underline{x}), (\bar{t}, \bar{x})\}} \left\{ \vartheta \left( \sigma \underline{t} + W_P - \pi(x) \left( D - (\beta \underline{t} - \underline{\theta x}) \right) - \underline{t} \right) + (1 - \vartheta) \left( \sigma \bar{t} + W_P - \pi(x) \left( D - (\beta \bar{t} - \theta x) \right) \right) \right\}$$

Under the incentive compatibility and participation conditions:

$$(20) \quad \begin{cases} \left( (1 - \pi(\underline{x})) (\beta \underline{t} - \underline{\theta x}) \geq (1 - \pi(\bar{x})) (\beta \bar{t} - \underline{\theta \bar{x}}) \right) \\ \left( (1 - \pi(\bar{x})) (\beta \bar{t} - \bar{\theta \bar{x}}) \geq (1 - \pi(\underline{x})) (\beta \underline{t} - \bar{\theta \underline{x}}) \right) \end{cases}$$

And,

$$(21) \quad \begin{cases} \left( (1 - \pi(\underline{x})) (\beta \underline{t} - \underline{\theta x}) \geq 0 \right) \\ \left( (1 - \pi(\bar{x})) (\beta \bar{t} - \bar{\theta \bar{x}}) \geq 0 \right) \end{cases}$$

Let us consider from (17) that:

$$(22) \quad (\beta \underline{t} - \underline{\theta x}) - \underline{U} = \pi(\underline{x}) (\beta \underline{t} - \underline{\theta x})$$

$$(23) \quad (\beta \bar{t} - \bar{\theta \bar{x}}) - \bar{U} = \pi(\bar{x}) (\beta \bar{t} - \bar{\theta \bar{x}})$$

Replace respectively  $\pi(\bar{x}) (\beta \bar{t} - \bar{\theta \bar{x}})$  and  $\pi(\underline{x}) (\beta \underline{t} - \underline{\theta x})$  by  $(\beta \underline{t} - \underline{\theta x}) - \underline{U}$  and  $(\beta \bar{t} - \bar{\theta \bar{x}}) - \bar{U}$  and  $\underline{t}$  and  $\bar{t}$ , by their corresponding values  $\underline{t} = \frac{\underline{x}}{1-\gamma}$  and  $\bar{t} = \frac{\bar{x}}{1-\gamma}$ . The program becomes:

$$(24) \quad \mathcal{L}((\underline{t}, \underline{x}), (\bar{t}, \bar{x})) = \text{Max}_{\{(\underline{t}, \underline{x}), (\bar{t}, \bar{x})\}} \left\{ \vartheta \left( \sigma \frac{\underline{x}}{1-\underline{\gamma}} + W_P - \pi(\underline{x})D + \left( \beta \frac{\underline{x}}{1-\underline{\gamma}} - \underline{\theta x} \right) \right) + (1-\vartheta) \left( \sigma \frac{\bar{x}}{1-\bar{\gamma}} + W_P - \pi(\bar{x})D + \left( \beta \frac{\bar{x}}{1-\bar{\gamma}} - \bar{\theta \bar{x}} \right) \right) - \vartheta \underline{U} - (1-\vartheta) \bar{U} \right\}$$

Subject to:

$$(25) \quad \underline{U} \geq \bar{U} + (1 - \pi(\bar{x}))\Delta\theta\bar{x}$$

$$(26) \quad \bar{U} \geq \underline{U} - \Delta\theta\underline{x}(1 - \pi(\underline{x}))$$

And  $\underline{U} \geq 0, \bar{U} \geq 0$

Identifying the binding constraints and checking whether the omitted constraints are strictly fulfilled simplifies the model (Laffont and Martimort (2002, chap.2)). Then, consider the set of contracts with  $\bar{x} > 0$ . The ability of the  $\underline{\theta}$ -agent to imitate the  $\bar{\theta}$ -agent implies that the  $\underline{\theta}$ -agent participation constraint  $\underline{U} \geq 0$  is always strictly satisfied. Indeed,  $\bar{U} \geq 0$  and  $\underline{U} \geq \bar{U} + (1 - \pi(\bar{x}))\Delta\theta\bar{x}$  imply immediately that  $\bar{x} > 0$ . If a list of contracts allows an inefficient agent to achieve his status quo utility level, it will be also the case for an efficient agent who can produce at a lower cost. Second, conceiving that  $\bar{U} \geq \underline{U} - \Delta\theta\underline{x}(1 - \pi(\underline{x}))$  means that an efficient agent would try to become inefficient which is non-sense. Consequently, the number of relevant constraints consists in the  $\underline{\theta}$ -agent's incentive constraint  $\underline{U} \geq \bar{U} + (1 - \pi(\bar{x}))\Delta\theta\bar{x}$  and the  $\bar{\theta}$ -agent's participation constraint  $\bar{U} \geq 0$ . Each constraint must be binding and then:

$$(27) \quad \underline{U} = \bar{U} + (1 - \pi(\bar{x}))\Delta\theta\bar{x} \text{ and } \bar{U} = 0$$

We replace these values in the ongoing program that expresses then only in  $\underline{x}, \bar{x}$  terms:

$$(28) \quad \mathcal{L}(\underline{x}, \bar{x}) = \text{Max}_{\{(\underline{x}, \bar{x})\}} \left\{ \vartheta \left( \sigma \frac{\underline{x}}{1-\underline{\gamma}} + W_P - \pi(\underline{x})D - \underline{\theta x} \right) + (1-\vartheta) \left( \sigma \frac{\bar{x}}{1-\bar{\gamma}} + W_P - \pi(\bar{x})D - \bar{\theta \bar{x}} \right) - \vartheta \left( (1 - \pi(\bar{x}))\Delta\theta\bar{x} \right) \right\}.$$

Considering the efficient type, we see that the expected rent is given up and does not depend on his level of care  $x$ . The following proposition ensues:

**Proposition 2:** *Under the program  $\mathcal{L}(\underline{x}, \bar{x})$ , there is no alteration of the first-best level of care concerning the efficient borrower:*

$$(29) \quad \underline{x}^{SB} = \underline{x}^*.$$

*However, there is a downward care distortion concerning the inefficient borrower:*

$$(30) \quad \bar{x}^{SB} < \bar{x}^* \quad \square$$

**Proof:** (in appendix).

Under asymmetric information, the efficient agent supplies the first-best level of care if the principal sacrifices an information rent to deter the efficient borrower to mimic the inefficient agent. The rent level corresponds to that benefit that she would get playing this mimetic strategy. Under a second best optimum, the  $\bar{\theta}$ -agent gets no rent as the above proposition shows it. The information rent allocated to the efficient agent depends on the level of due care demanded from the  $\bar{\theta}$ -agent. Then, the results are as follows. The principal must be able to show to the judge that he put in place an effective incentives mechanism. These incentives consist in determining a loan level that should allow the borrower to define a sufficient care level.

**Proposition 3:** *The optimal contract involves that the optimal transfers are:*

- For the efficient agent:

$$\bullet \quad \underline{t}^{SB} = \frac{1}{\beta} \frac{(1 - \pi(\bar{x}^{SB}))}{(1 - \pi(\underline{x}^*))} \Delta \theta \bar{x}^{SB} + \frac{1}{\beta} \theta \underline{x}^*,$$

- For the inefficient agent:

$$\bullet \quad \bar{t}^{SB} = \frac{1}{\beta} \theta \bar{x}^{SB}$$

- Then, the efficient agent gets an information rent equivalent to :

$$\bullet \quad \underline{U} = (1 - \pi(\bar{x})) \Delta \theta \bar{x} \quad \square$$

**Proof:** (in Appendix).

A contractual scheme that allows the lender to comply with both the regulator and Court requirements is possible. The principal proposes an optimal contract that involves granting a loan that integrates a rent information to the efficient agent only. Because of this contract, theoretically, the efficient borrower is induced to supply the socially first-best level of care.

## 2.5 Negligence rule: full agreement between the judge and the regulator concerning the socially optimal care level

The above model also applies to negligence. More elements are needed

### 2.5.1 The equilibrium condition

Here by assumption, both the regulator and the court agree on the level of the socially first best of care.

**Proposition 4:** *If  $(\underline{t}^{SB}, \underline{x}^*)$  is the ex-ante contractual set between the lender and the borrower, then, in case of an accident, the lender's wealth is:*

$$(31) \quad H(\underline{t}^{SB}) = \sigma \underline{t}^{SB} + W_p \square$$

**Proof:**

The lender may escape to any liability if he can show that he has offered the agent an efficient contract (propositions (2) and (3)). The contract terms should deter her to deliberately fail and induce her complying with the first-best level of care. Consequently, the lender takes into account this data, his expected wealth is:

$$(32) \quad EW_p^{NR} = \begin{cases} \sigma \underline{t}^* + W_p & \text{if } t \geq \underline{t}^* \\ \sigma \underline{t}^* + W_p - \pi(\underline{x}^*) (D - G(\underline{t}^*, \underline{x}^*)) & \text{if } t < \underline{t}^* \end{cases}$$

Finding the conditions  $(t < \underline{t}^*)$  and  $(t \geq \underline{t}^*)$  rather than conditions on the level of safety may seem surprising. This is due to vicarious liability situation where the lender controls only partially the borrower's behavior. Indeed, in the standard accident model, Shavell (1980), (1987) shows that the regulator can only endorse the socially optimal care level and the potential tortfeasor has the option to comply or not with this requirement. His self-interest and rationality involve that he will conform and adapt safety level to the first best level. The same argument applies only partially in the present vicarious liability scheme. Indeed, considering the contract that he proposes to the lender, he supplies  $\underline{t}^*$  knowing that he offers to the borrower sufficient means to let her implement  $\underline{x}^*$ . By doing so, he knows that it is a necessary condition to escape any liability in case of a harm occurrence. However, regardless the lender's determination of enforcing  $\underline{x}^*$ , complying or not with the socially first best of care depends on the borrower's will.

### 2.5.2 Enforcing the level of care $\underline{x}^*$ : a monitoring process

At this stage, after an accident, first, the judge must verify whether the lender funded enough the borrower for reaching the first best of care and, second, whether the latter reached this level. This double checking is necessary to determine the lender's effective liability. This

is typically a moral hazard problem because the borrower could use a fraction of  $\underline{x}^*$  to increase her production scale. Consequently, the lender has to monitor the borrower. Obviously, this monitoring is costly and a share  $\alpha$  of the interest parameter  $\sigma$  is included in the interest charge  $\sigma^{17}$ . However, developing here a monitoring system could lead too far without added value.

## 2.6 Negligence rule applied to the lender with no compliant judge

For a long time, contemporaneous literature develops the theme of errors made by Court (Calfee and Craswell (1984) and (1986), Goetz (1984), Polinsky and Shavell (1989), Kahan (1989), etc). These errors stem from the Court's lack of information about the nature and the extent of losses induced by victims, information asymmetries about the nature of technologies, production and safety costs, etc. Here, by assumption, both lender and borrower know that Courts can make mistakes and the lender assesses this probability. Consequently, even if the latter correctly behaves, the probability of being involved in liability is not null. This paper mainly aims at knowing, whether, in spite of disadvantages induced by vicarious liability, a contractual relationship could result in the enforcement of the socially first-best care level. Applying this to the model involves that when he designs the optimal contract:  $\{(\underline{t}^{SB}, \underline{x}^*), (\bar{t}^{SB}, \bar{x}^{SB})\}$ , the lender does not know exactly whether he will gain  $H(\underline{t}^{SB}) = \sigma \underline{t}^{SB} + W_p$  with a probability  $\mu$ , (where  $\mu, 1 \geq \mu \geq 0$  is the probability of no-mistake from the court's side.) Or, on the contrary, if he has to expect  $EW_p = \sigma \underline{t}^{SB} + W_p - \pi(\underline{x}^*) (D - G(\underline{t}^{SB}, \underline{x}^*))$  with a probability of  $(1 - \mu)$ . As expected, this contract will be affected by such an indetermination. Hence, the loan supplied by the principal corresponds to his program internal solution but not to the socially first-best level. Furthermore, even if the principal cannot enforce this level, he can induce the borrower conforming to the safety level he considers as sufficient. To show this, it is sufficient to see that the lender wealth's function is a convex combination of  $EW_p$  and  $H(t)$  in terms of  $\mu$ . The new lender's expected payoff  $EV_p^{NR}(t, x)$  becomes:

$$(33) EV_p^{NR}(\underline{t}^{SB}, \underline{x}^*) = H(\underline{t}^{SB}) - \mu\pi(\underline{x}^*) (D - G(\underline{t}^{SB}, \underline{x}^*))$$

This amounts to modifying the probability distribution of accident and, consequently the care equilibrium level. As this does not change the lender's situation, he can define a credible ex-ante contract for deterring the efficient borrower from failure and defining an accurate safety level. Therefore, even, if the probability to enforce the first-best care is very low, the lender offers the agent the means for higher safety. Despite this caveat, negligence remains a better regime than strict liability.

Is this argument naïve? Indeed, the agents could induce lenders to provide funds but then cheat them as to their ultimate object. However, in developed economies, resorting to civil liability does not prevent the victims from invoking criminal law. For instance, the lender may prove that the agent has voluntarily veiled information (Copland 2010) and sue the facility's owners or managers on grounds of criminal law. However, contrary to (Demougin and Fluet 1999), the lender cannot easily modulate incentive tools to encourage the operator supplying the highest safety effort. Indeed, the lender can only expect a given level of return (interest rates). Hence, the function is highly dependent on the lending conditions. The lenders could adapt some premium for compliant operators.

Here, the Laffont and Boyer's "partial liability" means that the banks are liable when they imperfectly monitor their loan. They escape from liability if they may prove that they have correctly monitored the complying with law agent. Compared to the current situation in

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<sup>17</sup> For a complete view see for instance (Demougin and Fluet (2001)).

CERCLA, the advantage is obvious. First, the probability of full internalization increases because, potentially, the lenders can be involved in the repair process. Second, the lender fully acts as a principal by requiring from his client a full compliance with safety rules.

## 2.7 Strict liability applied on lenders

Without the 1996's Amendments, the law case evolution would have led the United States applying strict liability on both lenders and borrowers. Whether negligence or strict liability regimes, the lender disposes of few means to induce the operator complying with the optimal care level. However, under negligence the lender may escape any liability if he shows that he induced the borrower conforming to Law. This is not the case under strict liability where the lender has to repair whatever his involvement in prevention. Without specific assumption, the lender cannot observe the agent's care effort. In Demougin and Fluet (1999), the principal can reward at random (probability given) the agent's most favorable result and penalizes her with a corresponding probability. Here, the agent feels no incentives to inform the principal about her care effort. The situation is clearly moral hazard. Even if considering the loan as a reward (because it allows the agent to achieve her gain), nothing prevents her from cheating and breaching the contract terms without further specification. Under strict liability, the Banks have to induce the borrowers supplying the highest level of effort. However, the agents could prefer to become judgment-proof because the lender will be responsible for them (Shavell 1986), (van't Veld 1997), (van't Veld 2006). The latter author shows that imposing strict liability rules induces changes in the composition of the firm's capital as in the oil shipping sector before the enactment of the U.S. Oil Pollution Act of 1990 (Van't Veld (2006)). Consequently, oil companies subdivided the tanker into single ships companies (the same occurred in the taxi sectors (Spear and Che 2008)).

When strict liability applies to borrowers and lenders, the regulator can hardly implement the socially first-best safety level. The lender occupies an intermediary position between the regulator and the operator. Hence, when he faces the regulator, the lender acts as an agent because the regulator is the principal. Then, when facing the borrower, the lender becomes the principal. This is the root of vicarious liability and under this conjecture, the borrower "leads the game" (i.e. she fixes the care level to maximize her profit). This conception is the "shadow" proposal of Laffont and Boyer (1997). Indeed, these authors show that full repairing damages involve making banks as liable as the firms they finance. However, this involves a thorough and complete check of the borrower by the lender, which is true neither in the model nor in reality.

Then, how can the agent comply with the socially first-best level of care  $x^*$ ? Every player follows his own interest and without incentive, he achieves his individual objectives independently from the regulator's requirement. Under strict liability, the government cannot directly influence the relationship between the lender (principal) and the agent (borrower). This prevents reaching the optimal prevention level. Furthermore, the lenders might be reluctant financing risky projects because, whatever their effort for insuring a high care level, any harm engages their liability. This leads to "kill" the investment.

Formally, under vicarious liability and after a harm occurrence, applying strict liability on both lender and borrower involves that the lender must repair

$(D - (\beta \underline{t}^{SB} - \theta \underline{x}^*))$  and his payoff function is:

$$EW_P^{SL} = \sigma \underline{t}^{SB} + W_P - \pi(\underline{x}^*) (D - (\beta \underline{t}^{SB} - \theta \underline{x}^*)), 1 > \pi(\underline{x}^*) > 0.$$

Consequently, with strict liability under vicarious liability, the lender is not induced to supply the required level of loan. This regime leads to "kill" investment in the Laffont-Boyer's words. We can check that this result is independent from a monitoring made by the lender.

### 3. Conclusion and proposal

Without a shred of doubt, financing ultra-hazardous activities involves sharing a moral responsibility in the accident occurrence with the polluters. However, in most countries, exemption rules prevent it turning out into legal liability. Furthermore, the legal cases show that the lenders' involvement is much more due to their operational than their financing activities. However, extending liability to lenders may come in the forefront at any time under the public opinion pressure.

1. The early experience of CERCLA showed that extending strict liability to lenders could "kill" the investment. The 1996 amendments reinforced the liability exemption by explicitly further restricting the lenders' involvement. However, this choice removes all possibilities for lenders to play an active role as principals in the environmental protection process except if they explicitly manage or own the facility. Effectively restoring this role entails extending negligence to lending activities. Consequently, lenders may escape from liability if they can prove that, as principal, they did induce the agent complying with law. This change re-establishes the lender as principal and reconnects with recent economic literature. Hence, applying strict liability to the borrower and negligence to the lender for lending activities gives better results than enforcing strict liability on both of them. Under negligence, the principal supplies a more relevant loan than under strict liability where the temptation of under sizing it remains strong.

2. Negligence applied for lending does not preclude involving the lender's liability for ownership or management activities. As far as environmental safety is concerned, lenders partially participate in securing the production, stocking and cleaning-up processes. Negligence applies to them if they supply loans without checking the firms' compliance with safety rules. This scheme gives high capability to the lenders as principals. They can condition their loan to conform to environmental rules. This extends all along the maturity of the loan. This proposal meets and completes the theoretical advances of (Pitchford 1995), (Boyer and Laffont 1997) or also (Boyer and Porrini 2009). Indeed, in a moral hazard environment, these authors show that limited bank liability is preferable to complete liability. Our model defines a liability framework for both the lender and the operator. It applies negligence to lenders and strict liability to operators and owners. Hence, the lender may evade its liability if he can prove that, as principal, he induced the borrower to suitably obey to environmental and safety rules. Consequently, the polluter bears the repair burden alone.

3. To assess the lenders' liability, Courts need examining three factors. First, they have to check "in the absolute" the accuracy of the measures that the principal required from the agent. Second, they appraise the principal's capacity to implement the whole set of measures by evaluating the mutual bargaining power between the agent and the principal (Balkenborg 2001). Third, the Court looks at the causal link that involves the operator/owner according the strict liability rule. The first two items are essential to determine the principal's liability. Insufficient safety effort will entail the principal's liability.

4. Exempting the lender from liability through negligence rule involves modifying environmental legislations drastically. For instance, CERCLA allocates liability through ownership and/or control motives. Introducing negligence rule for lending entails renewing the safe harbor provision (i.e. the SIE). Hence, to make lenders free from liability, two conditions should be gathered. First, their close monitoring about the borrower's compliance with environmental safety and, second, be sure that exemption about management and ownership has been respected fully.

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## Appendix

**Proof of Proposition 2:** Under the program  $\mathcal{L}(\underline{x}, \bar{x})$ , there is no prevention alteration concerning the efficient agent:

-  $\underline{x}^{SB} = \underline{x}^*$ .

However, there is a downward distortion concerning the inefficient one:

-  $\bar{x}^{SB} < \bar{x}^*$   $\square$

-

**a. The efficient agent:**

- It is sufficient to look for the first order conditions:

$$(1B) \quad \frac{\partial \mathcal{L}(\underline{x}, \bar{x})}{\partial \underline{x}} = 0 \implies \frac{\sigma}{1-\underline{\gamma}} - \pi'(\underline{x})D + \left( \beta \frac{1}{1-\underline{\gamma}} - \underline{\theta} \right) = 0$$

and then, it exists  $\underline{x}^{SB}$  such that :

$$(2B) \quad \pi'(\underline{x}^{SB}) = \left( \frac{\beta-1}{1-\underline{\gamma}} \right) \frac{1}{D}$$

and, consequently,

$$\underline{x}^{SB} = \underline{x}^*$$

**b. The inefficient agent:**

- Then considering the inefficient agent, we have to find  $\bar{x}^{SB}$  such that:

$$(3B) \quad \frac{\partial \mathcal{L}(\underline{x}, \bar{x}^{SB})}{\partial \bar{x}^{SB}} = 0 \implies (1 - \vartheta) \left( -\pi'(\bar{x}^{SB})D + \left( \beta \frac{1}{1-\bar{\gamma}} - \bar{\theta} \right) \right) - \vartheta \Delta \theta \left( 1 - \pi(\bar{x}^{SB}) - \pi'(\bar{x}^{SB}) \right) = 0.$$

At first sight, it seems difficult to make inferences about the relationships between  $\bar{x}^*$  and  $\bar{x}^{SB}$ . To deal with this point, let us consider that  $\mathcal{L}(\underline{x}, \bar{x}) = \mathcal{L}_1(\underline{x}) + \mathcal{L}_2(\bar{x})$ .

Where:

$$(4B) \quad \mathcal{L}_1(\underline{x}) = \vartheta \left( \sigma \frac{\underline{x}}{1-\underline{\gamma}} + W_P - \pi(\underline{x})D - \underline{\theta}\underline{x} \right) \text{ and}$$

$$(5B) \quad \mathcal{L}_2(\bar{x}) = (1 - \vartheta) \left( \sigma \frac{\bar{x}}{1-\bar{\gamma}} + W_P - \pi(\bar{x})D - \bar{\theta}\bar{x} \right) - \vartheta \left( (1 - \pi(\bar{x}))\Delta\theta\bar{x} \right)$$

We know that:  $EWS(\bar{x}) = \sigma \frac{\bar{x}}{1-\bar{\gamma}} + W_P - \pi(\bar{x})D + \left( \beta \frac{\bar{x}}{1-\bar{\gamma}} - \bar{\theta}\bar{x} \right)$ ,

And, consequently :

$$(6B) \quad \mathcal{L}_2(\bar{x}) = (1 - \vartheta)EWS(\bar{x}) - \vartheta \left( (1 - \pi(\bar{x}))\Delta\theta\bar{x} \right)$$

. Then, we express the value of  $\frac{\partial \mathcal{L}(\bar{x}^*)}{\partial \bar{x}^*}$  for  $\bar{x}^*$ ,

$$(1B) \quad \frac{\partial \mathcal{L}(\bar{x}^*)}{\partial \bar{x}^*} = (1 - \vartheta) \frac{\partial EWS(\bar{x}^*)}{\partial \bar{x}^*} - \vartheta \Delta \theta \left( \frac{\partial \left( (1 - \pi(\bar{x}^*))\bar{x}^* \right)}{\partial \bar{x}^*} \right) = \vartheta \Delta \theta \left( \left( 1 - \pi(\bar{x}^*) \right) - \bar{x}^* \pi'(\bar{x}^*) \right) \leq 0,$$

At first sight we do not know whether  $\bar{x}^{SB} \leq \bar{x}^*$ .

However, as  $\frac{\partial EWS}{\partial x}(x^*) = 0$ , obviously,  $\frac{\partial EWS}{\partial x}(\bar{x}^*) = 0$ , then,

$$(2B) \quad \mathcal{L}(\underline{x}, \bar{x}) = \text{Max}_{\{(\underline{x}, \bar{x})\}} \left\{ \vartheta \left( (EWS(\underline{x})) + (1 - \vartheta)(EWS(\bar{x}) - \vartheta \left( (1 - \pi(\bar{x}))\Delta\theta\bar{x} \right)) \right) \right\}.$$

$$(3B) \quad \frac{\partial \mathcal{L}(\underline{x}, \bar{x}^*)}{\partial \bar{x}^*} = 0 + \frac{\partial EWS}{\partial x}(\bar{x}^*) - \vartheta\Delta\theta \left( 1 - \pi(\bar{x}^*) - \bar{x}^* \pi'(\bar{x}^*) \right)$$

$$(7B) \quad \frac{\partial \mathcal{L}(\underline{x}, \bar{x}^*)}{\partial \bar{x}^*} = 0 - \vartheta\Delta\theta \left( 1 - \pi(\bar{x}^*) - \bar{x}^* \pi'(\bar{x}^*) \right) < 0$$

(Indeed,  $(1 - \pi(\bar{x}^*)) > 0$ ,  $\vartheta, \Delta\theta > 0$ ,  $\bar{x}^* \pi'(\bar{x}^*) < 0$ ).

As  $EWS(x)$  is concave  $\left( \frac{\partial^2 EWS}{\partial x^2} \leq 0 \right)$ , that means that at  $\bar{x}^*$ ,  $(1 - \vartheta)(EWS(\bar{x}) - \vartheta \left( (1 - \pi(\bar{x}))\Delta\theta\bar{x} \right))$  is below  $EWS(x)$  and reaches its maximum  $\bar{x}^{SB}$  at a lesser value than  $\bar{x}^*$ . Consequently,  $\bar{x}^* \geq \bar{x}^{SB}$   $\square$

### Proof of Proposition 3:

#### a. The efficient agent:

- Let us consider:

$\underline{U} \geq \bar{U} + (1 - \pi(\bar{x}))\Delta\theta\bar{x}$  and as  $\underline{U} = (1 - \pi(\underline{x}))(\beta t - \theta x)$  and, as  $\bar{U} = 0$ , as binding condition, the result ensues.

$$\bullet \quad \underline{t}^{SB} = \frac{1}{\beta} \frac{(1 - \pi(\bar{x}^{SB}))}{(1 - \pi(\underline{x}^*))} \Delta\theta\bar{x}^{SB} + \frac{1}{\beta} \theta x^*,$$

#### b. The inefficient agent:

- As  $\bar{U} = (1 - \pi(\bar{x}^{SB}))(\beta t^{SB} - \theta \bar{x}^{SB}) = 0$  and as  $1 - \pi(\bar{x}^{SB}) \neq 0$  by definition, then

$$\bar{t}^{SB} = \frac{1}{\beta} \theta \bar{x}^{SB}$$

- The efficient's agent rent equals  $\underline{U} = (1 - \pi(\bar{x}))\Delta\theta$  deduces from the fact that  $\bar{U} = 0$   $\square$

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