

LENDER LIABILITY AND DUE DILIGENCE FOR ENVIRONMENTAL AND SOCIAL HARM: A COMPARATIVE ANALYSIS



Acknowledgments

The report was prepared by the International Organizations (IO) Clinic at NYU School of Law.*

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Introduction

New York University School of Law International Organizations Clinic (“the Clinic”) has undertaken:

- 1) Research into lender liability for environmental and social harm in the US, UK (including relevant EU legislation & case law) and Hong Kong; and
- 2) Research into whether and if so how human rights due diligence relates to legal liability for lenders in those jurisdictions,

These particular jurisdictions were selected due to their prominence in choice-of-law clauses in international transactions.¹ In addition, a briefer survey of the same questions in a number of other potentially relevant jurisdictions (Australia, Brazil, Canada, and New Zealand) was carried out.

A. Main findings

As indicated in greater detail below, neither the U.S., UK/EU, nor Hong Kong has a robust lender liability framework.² The instances in which lender liability for environmental or social harm is contemplated in these major jurisdictions are limited in scope, and lenders can generally avail of a variety of legal shields to protect themselves from such liability. The absence of any real risk of lender liability in these and jurisdictions removes one major argument sometimes raised by multilateral development banks (MDBs) against the proposal that they should engage in heightened due diligence activities concerning social, environmental or human rights risks. The existing legal frameworks in the U.S., UK/EU, and Hong Kong should assure MDBs that they can engage in a broad spectrum of robust due diligence activities without triggering lender liability. Instead, they are in a position to reap the moral, reputational and practical benefits of conducting broader social, environmental and human rights due diligence without incurring additional risk.

B. Lender liability for environmental and social harm in the U.S., U.K. (including relevant EU legislation) and Hong Kong

The analysis carried out below indicates that while there are legal provisions in each of the selected jurisdictions which contemplate lender liability for environmental harms, and also, in a limited number of instances, for social harms, this liability is largely circumscribed by various exceptions and protections enshrined both in legislation and case law.

In the U.S., there are two broad forms of lender liability: ‘control’-based liability, and ‘aiding and abetting’ liability. The former covers situations in which a lender wields effective control over the project in which it has invested, to such an extent that it can be deemed liable for harms caused by the project or the borrower. Aiding-and-abetting liability deals with circumstances in which the lender knowingly assisted the borrower in the conduct of certain types of illegal activity.

Lender liability for *environmental* harm is a form of ‘control liability’ governed by the US Comprehensive Environmental Response, Compensation, and Liability Act (“CERCLA”). CERCLA, despite contemplating lender liability, also includes a broad “secured creditor exemption.” This exemption allows lenders to avoid liability for environmental damage caused by

¹ <https://www.cogencyglobal.com/blog/the-benefits-of-choosing-new-york-law-in-cross-border-financial-transactions>

² A more robust lender liability framework exists in Brazil, but for now it seems to be less central as a global commercial jurisdiction than the U.S., UK/EU, and Hong Kong.

their borrowers, as long as the lenders do not actively participate in the day-to-day management of the borrower's project to the extent of exercising decision-making control over the project's environmental compliance. Given the broad latitude which exists for lenders to conduct activities with respect to the project that do not trigger liability, however, this framework allows lenders to exercise environmental due diligence to minimize such risks, without exposing the financial institution to liability.

Lender liability for *social* harms in the US arises primarily under the Alien Tort Claims Act ("ATCA"). Lender liability under ACTA is best understood as a form of aiding and abetting liability. The Act grants federal courts jurisdiction over claims brought by foreign citizens for torts committed in violation of international law, including international human rights law. While ATCA covers a potentially wide range of human rights abuses, lenders can generally avoid liability so long as they do not actively commit or participate in human rights violations, and so long as they provide little more than monetary contribution to their borrowers. Similar to the environmental harms context of CERCLA, banks and lenders are therefore highly likely to be able to conduct human rights due diligence without exposing themselves to lender liability, should human rights violations occur despite their due diligence.

In the United Kingdom (including as affected by European Union law pre-Brexit, and likely by retained EU law post-Brexit), environmental liability is governed mainly by legislation. However, the risk of lender liability for environmental harm is largely curtailed by the polluter-pays principle, by definitions of 'operator' or 'owner' that focus on operational control, and by mechanisms such as the ability to request a court release from onerous remediation costs assumed after a borrower enters bankruptcy. As far as lender liability for social harm is concerned, the UK common law of negligence rather than legislation plays a larger role. Doctrinal limitations on the duty of care generally insulate corporate parents, and, by extension arguably lenders too, from liability in most cases. Nonetheless, a recent line of case law suggests greater willingness on the part of courts to impose a duty of care based on the particular relationship between a parent company and its operational subsidiary (and, arguably, by analogy, the particular relationship between a lender and a borrower), drawing on corporate group-wide policies as the basis for finding the imposition of such a duty as reasonable and just. Alongside trends in reporting requirements and due diligence requirements, further development of this line of cases might possibly herald a future extension of lender liability for environmental and social harms.

In Hong Kong, the legal framework through which lender liability is contemplated for environmental and social harm is not as comprehensive as those of the U.S. and UK, and is still developing. With respect to environmental harms, lender liability is mainly governed by statutory law and government regulations. The current law appears to make it difficult to pursue liability on the part of lenders. Under current environmental legislation, including Environmental Impact Assessment Ordinance (Cap.499), Water Pollution Control Ordinance (Cap. 358), and Waste Disposal Ordinance (Cap. 354), a lender is unlikely to be subject to liability for environmental damage in connection with a borrower's failure to comply with relevant legislation, so long as the lender holding or enforcing security over real estate or land does not participate in the operations or management of the borrower or security provider/guarantor, or knowingly permit the operations that caused the contamination to the environment. However, the exercise of "step-in" rights on a security provider default may give rise to primary liability. In practice, lenders can protect

themselves against potential environmental liability by implementing a broad range of precautionary measures, carrying out environmental due diligence checks, and purchasing environmental insurance.

In recent years, the Hong Kong governmental agencies have taken initiatives encouraging, and in some circumstances mandating companies to conduct environmental due diligence for their businesses. For instance, under the *Environmental, Social and Governance Reporting Guide*, listed companies on the Hong Kong Stock Exchange, including commercial banks, must publish mandatory environmental, social, and governance (“ESG”) reports that include disclosures on their environmental practice, including significant climate-related issues which may impact the company; practices used to identify environmental risks along the supply chain; and practices used to promote environmentally preferable products and services when selecting suppliers. If the company fails to report on one or more of the “comply or explain” provisions, it must provide considered reasons in its ESG report. With respect to liability for non-compliance, in theory, companies that fail to submit the report will be in breach of the listing rules and could put their listing in jeopardy. Non-compliance could also possibly tarnish their reputation in the investing community, potentially affecting the share price, and among civil society, activist groups and current and would-be employees.

However, commercial banks are not likely to be held legally liable under this framework for their non-compliance with the reporting requirement. Additionally, the Hong Kong Monetary Authority has also promoted an initiative called *Sustainable Banking and Green Finance* to address potential environmental impacts of banking activities. While this framework encourages banks to develop sustainability-related business, the regulatory focus remains on climate-related risks. Under this framework, banks are not expected to manage their impact on climate, biodiversity, or other environmental impact as long as that impact is not financially material to them. The framework does not require banks to consider disclosing information about their lending portfolio contributing to climate change mitigation and adaptation. Therefore, there is no enforcement or sanction mechanism built in the framework. .

Regarding social harms, Hong Kong has a relatively established legal framework that prohibits certain social harms that might arise in corporate activities, which presumably includes those of commercial banks, and imposes potential civil/criminal sanctions on corporations. This framework includes the following major statutes: Bill of Rights Ordinance (Cap. 383), Crimes Ordinance (Cap. 200), Human Organ Transplant Ordinance (Cap. 465), and Employment Ordinance (Cap. 57). However, these statutes do not specifically address the liability of commercial banks or private lenders. Thus, it is unclear whether commercial banks could be held liable under one of these for social harm caused in connection with their investments.

C. The relationship between human rights due diligence and legal liability for lenders in the US, the UK/EU and Hong Kong

Although U.S. law provides two important statutory venues – CERCLA and ACTA - through which third party plaintiffs may vindicate their rights in cases of environmental and social harm, there seems to be no mandatory requirement on banks to conduct human rights due diligence. While voluntary due diligence practice by banks does not appear to expose them to any further lender liability (and indeed such due diligence may provide certain legal defenses to liability, as

discussed in greater detail below), banks may need further encouragement to adopt regular due diligence practices.

Broadly speaking, while UK (and EU) law establish due diligence requirements in specific sectors, e.g., timber or ore import industries in the EU, and bribery in the UK, there is no framework which clearly establishes the relevance of due diligence to liability (or the absence of liability). The EU and UK have adopted mandatory disclosure rules in relation to non-financial risk, but they do not clarify what relevance these may have to liability, whether as a defense or otherwise. EU law imposes more extensive due diligence requirements in certain sectors such as timber and ore importation, but these are not, in the main, relevant to lenders. Lastly, Directive 2009/52/EC of the European Parliament and of the Council of 18 June 2009 provides for the possibility of joint and several liability for subcontractors who employ illegally remaining third-country nationals, but provides a due diligence defense which is similar to the “adequate procedures” defense under the UK Bribery Act 2010. At present, these appear to be the only UK or EU laws which explicitly connect due diligence to liability for environmental and social harms. However, EU initiatives are currently underway to connect reporting and due diligence requirements more explicitly to liability regimes across industries EU-wide. Along with the case-law discussed above, these ongoing developments arguably reflect a broader trend towards incentivizing lenders to conduct extensive human rights due diligence.

In Hong Kong, there is an apparent move at present towards establishing laws which impose mandatory disclosure of human rights risks by corporations, including commercial banks. For instance, under the ESG Reporting Guide of HKEx, listed companies, including commercial banks, are required to disclose information on certain social practices in relation to employment and labor standards (e.g. child and forced labor), amongst others. For instance, listed companies are advised to conduct due diligence to prevent child and forced labor within their activities and to avoid contributing to or becoming linked with the use of child and forced labor through their relationships with others (e.g. suppliers and clients). However, the “comply or explain” approach applies only to some social key performance indicators and not for all social impacts. Further, the provisions on reporting child and forced labor are recommended rather than mandatory. Similar to the sanction which applies for non-compliance with environmental due diligence, companies that fail to submit the report on labor practices will be in breach of the listing rules and could put their listing in jeopardy. Non-compliance could also possibly tarnish their reputation in the investing community, potentially affecting the share price, and among civil society, activist groups and current and potential future employees. Furthermore, the Hong Kong legislature is currently considering draft legislation which, if enacted, will require certain companies—including those incorporated outside of Hong Kong—to publish a “slavery and human trafficking statement.” Under the current proposal, commercial banks will likely be covered under the Draft Bill. The Hong Kong Draft Modern Slavery Bill would go further than the existing U.K. Act in that it would create a host of criminal and civil offenses related to modern slavery and would empower courts to issue orders to prevent certain corporations from committing those offenses. If enacted, this Draft Bill would add to the increasingly complex landscape of national laws that place direct obligations on companies to identify and eliminate modern slavery from their own operations and from the operations of those companies’ business partners.

D. Methodology and Structure of the Report

The analysis contained in this Report is based on the examination of publicly available information about relevant legislative developments in the U.S., U.K., E.U. and Hong Kong, including case law at national, regional, and international level, academic papers, practical law resources, and publications of governments and international organizations, with a focus on the potential liability of commercial lenders under civil, criminal, and regulatory law, considering both common law and statutory law and a range of sectoral bodies of law, including environmental, administrative, tort, corporate, contract, financial, and human rights law.

This Report explores the scope and extent of lender liability for environmental and social harm as well as environmental and human rights due diligence in three main jurisdictions: the U.S., U.K., (including some E.U. coverage) and Hong Kong. In addition to these selected jurisdictions, a more limited analysis of the position governing lender liability in several other states was conducted, including Australia, Brazil, Canada, and New Zealand. Section II(A) explores the U.S.; Section II(B) explores U.K. and E.U. law. Section III(C) examines Hong Kong; and Section II(D) provides an overview of the other selected jurisdictions.

I. Analysis

A. The United States

1. General Sources of Lender Liability under United States Law

In the United States, theories of lender liability resulting from a borrower's misconduct generally fall into two categories: (a) control liability and (b) aiding and abetting.

a) Control Liability

A lender may be exposed to liability for harm caused by a borrower if the lender exercises too much control over the management, policies, and daily operations of the borrower. A range of statutory liabilities, including violations of federal securities law, environmental law, tax law, and racketeering law, as well as quasi-statutory and common law doctrines under which the lender may be found liable for other creditors of the borrower fall into this broad category. While these instances of potential lender liability all flow from the lender's control over the borrower's operations, different outcomes may arise in cases with similar facts, as the underlying policy considerations differ according to each source of liability.³

(1) Federal Securities Laws

The Securities Act of 1933 and the Securities Exchange Act of 1934 provide that "controlling" persons or entities shall be held jointly and severally liable for securities violations that are committed by the person or entity whom they controlled. Both statutes have exceptions to this control liability: the 1933 Act exempts liability for defendants who demonstrate that they did not know or had no reasonable grounds to believe in the existence of the violation, while the 1934 Act does not impose liability on defendants who acted in good faith and did not induce the commission of violation.⁴

While the statutes are silent on what exactly "control" means, regulations promulgated by the Securities and Exchange Commission define control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract, or otherwise."⁵ Courts require proof that the alleged controlling person or entity had sufficient power over the controlled person or entity to influence its behavior.⁶ In other words, a lender will not be deemed liable for the borrower's acts of violation if the lender (a) does not control the borrower's daily operations, (b) does not know or participate in the act of violation, and (c) does not attempt to exercise control over the acts of violation.⁷

³ See Lawrence, "Lender Control Liability: An Analytical Model Illustrated With Applications to the Relational Theory of Secured Financing," 62 So. Cal. L. Rev. 1387, 1390-1394 (1989).

⁴ The relevant sections in the two statutes use different language but are interpreted as having identical standards. *Pharo v. Smith*, 621 F.2d 656, 672-673 (5th Cir. 1980)

⁵ 17 C.F.R. § 230.405.

⁶ In re *General Electric Co. Securities Litigation*, 2012 U.S. Dist. LEXIS 4023 at *89-*90 (S.D.N.Y. Jan. 11, 2012), reconsideration granted in part 856 F. Supp.2d 645 (S.D.N.Y. 2012), quoting In re *Adelphia Communications Corp. & Derivative Litigation*, 398 F. Supp.2d 244, 262 (S.D.N.Y. 2005); *Ayers v. Wolfenbarger*, 491 F.2d 8 (5th Cir. 1974); *SEC v. Todd*, 642 F.3d 1207, 1223 (9th Cir. 2011).

⁷ *Sanders Confectionery Products, Inc. v. Heller Financial, Inc.*, 973 F.2d 474, 486 (6th Cir. 1992) (representations of 'potential control' do not equate to demonstrations of 'actual control'); *Metge v. Baehler*, 762 F.2d 621, 630-632 (8th Cir. 1985).

Courts have rejected liability in instances where the lender's activities do not rise to the level of "actual control." Lenders have been found not to be liable for: making and monitoring loans⁸, having merely the ability to "persuade and give counsel" to the management⁹, periodically receiving financial statements and sales reports from the borrower, or occasionally inspecting the construction site of the project being financed¹⁰. On the other hand, liability has been imposed when the lender actively controls the daily operations of the borrower. In *Technology Exchange Corp. v. Grant County State Bank*, the court found that the lender assumed a controlling status when it hired consultants and accountants specialized in the borrower's industry, reviewed and approved expenditures, and threatened to foreclose if the borrower did not meet its demand.¹¹ A bank may also be liable if its subsidiary has the power to control the borrower's actions.¹²

b) Aiding and Abetting

Under the common law theory of aiding and abetting tortious conduct, a lender may incur secondary liability for a borrower's misconduct because of its assistance to the borrower. In particular, liability may be imposed if the defendant bank knows that its borrower's conduct constitutes a breach of duty to a third party, and gives substantial assistance to the borrower to perform such conduct.¹³

(1) Aiding and Abetting Fraud

Lenders may be liable to plaintiffs who have been defrauded by their borrowers, if the lenders knew of the borrowers' fraudulent activities and provided substantial assistance to the conduct of those activities.¹⁴ To satisfy the knowledge requirement, the defendant bank must have actual knowledge of the specific fraud that harmed the plaintiff.¹⁵ Mere suspicion of unlawful activity,¹⁶ or knowledge of wrongdoing unrelated to the alleged fraud, does not suffice.¹⁷ Similarly, inferences that the bank *should have known* the alleged fraud was conducted do not give rise to an inference actual knowledge.¹⁸ It is worth noting, however, that liability may be found if a bank

⁸ *Sanders Confectionery Products, Inc. v. Heller Financial, Inc.*, 973 F.2d 474, 486 (6th Cir. 1992).

⁹ *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 949 (7th Cir. 1989), quoting *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 494 (7th Cir. 1986).

¹⁰ *Fuls v. Shastina Properties, Inc.*, 448 F. Supp. 983, 989 (N.D. Cal. 1978).

¹¹ *Technology Exchange Corp. v. Grant County State Bank*, 646 F. Supp. 179 (D. Col. 1986).

¹² *Index Fund, Inc. v. Hagopian*, 609 F. Supp. 499 (S.D.N.Y. 1985) (the bank owned a company that controlled 42% of the shares of the defrauding company).

¹³ Restatement (Second) of Torts § 876(b).

¹⁴ *Wight v. BankAmerica Corp.*, 219 F.3d 79, 46 Fed. R. Serv. 3d 1372 (2d Cir. 2000) ("...a claim for aiding and abetting fraud requires plaintiff to plead facts showing 'the existence of the fraud, defendant's knowledge of the fraud, and that the defendant provided substantial assistance to advance the fraud's commission.'").

¹⁵ *Lerner v. Fleet Bank, N.A.*, 459 F.3d 273, R.I.C.O. Bus. Disp. Guide (CCH) P 11114, 60 U.C.C. Rep. Serv. 2d 691 (2d Cir. 2006) (interpreting New York law, actual knowledge is required to impose liability for aiding and abetting fraud).

¹⁶ *El Camino Resources Ltd. v. Huntington Nat. Bank*, 712 F.3d 917 (6th Cir. 2013).

¹⁷ *El Camino Resources, LTD. v. Huntington Nat. Bank*, 2010 WL 2651617 *48 (W.D. Mich. 2010).

¹⁸ *Varga v. U.S. Bank Nat. Ass'n*, 2013 WL 3338750 (D. Minn. 2013).

investigates alleged fraudulent transactions and demands the closing of fraudulent accounts, but nevertheless continues to process transactions made through such accounts.¹⁹

Regarding the substantial assistance requirement, courts have held that providing financing to the borrower's tortious business operations may trigger lender liability so long as the knowledge requirement is also met.²⁰ Providing deposit account products, on the other hand, is not sufficient.²¹

(2) *Aiding and Abetting Breach of Fiduciary Duty*

If the borrower breaches a fiduciary duty to a third party, its lender may incur liability if the lender knew of the breach and provided substantial assistance.²² However, if the lender does not know the existence of the fiduciary relationship, no liability can be found.²³

Similar to aiding and abetting fraud, a finding of liability for aiding and abetting breach of fiduciary duty requires actual knowledge and not inferred knowledge based on negligence or recklessness.²⁴ Regarding substantial assistance, providing a line of credit or overdraft financing to a borrower who engaged in fraudulent activity does not amount to substantial assistance.²⁵ However, liability may ensue if the lender is also aware of other facts that give rise to the suspicion that fiduciary duties were being breached.²⁶

A related scenario involves a lender's inducement of its borrower to breach its fiduciary duty to a third party, which may result in liability for the lender for the damages caused to the third party. The defendant bank must have knowingly induced or participated in the breach.²⁷ In one case, inducement was found for a bank which, in negotiating a loan with one partner of a general partnership, withheld material facts from the other partner who was unaware of the status of the negotiation, while fully aware that the transaction violated the latter's right as a partner.²⁸

(3) *Aiding and Abetting Terrorist Acts*

According to the standard of aiding and abetting used under the Alien Tort Claims Act, the provision of funds has been held to be too far removed from the actual tortious conduct to satisfy

¹⁹ *Lesti v. Wells Fargo Bank, N.A.*, 2013 WL 1137482 (M.D. Fla. 2013) (noting that the claim would not be dismissed where plaintiff showed that bank conducted an investigation in accounts used in Ponzi scheme and requested that they be closed but nevertheless continued to process millions of dollars of item through the accounts).

²⁰ *In re First Alliance Mortg. Co.*, 471 F.3d 977, 995, 47 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 80802 (9th Cir. 2006); *Ge Dandong v. Pinnacle Performance Ltd.*, 2013 WL 4482509 (S.D.N.Y. 2013).

²¹ *American Bank of St. Paul v. TD Bank, N.A.*, 713 F.3d 455, 463, 91 Fed. R. Evid. Serv. 281 (8th Cir. 2013).

²² *Lerner v. Fleet Bank, N.A.*, 459 F.3d 273, R.I.C.O. Bus. Disp. Guide (CCH) P 11114, 60 U.C.C. Rep. Serv. 2d 691 (2d Cir. 2006); *Lamm v. State Street Bank and Trust*, 749 F.3d 938 (11th Cir. 2014).

²³ *In re Meridian Asset Management, Inc.*, 296 B.R. 243 (Bankr. N.D. Fla. 2003).

²⁴ *Wight v. Bank America Corp.*, 219 F.3d 49 (2d Cir. 2000); *Fort v. Suntrust Bank*, 2016 WL 4492898 (D.S.C. 2016).

²⁵ *Chance World Trading E.C. v. Heritage Bank of Commerce*, 438 F. Supp. 2d 1081 (N.D. Cal. 2005). *But see In re Section 1031 Exchange Litigation*, 716 F. Supp. 2d 415 (D.S.C. 2010) (finding that numerous ordinary transactions may be sufficient).

²⁶ *Liu Yao-Yi v. Wilmington Trust Company*, 301 F. Supp. 3d 403 (W.D. N.Y. 2017).

²⁷ *Whitney v. Citibank, N.A.*, 782 F.2d 1106 (2d Cir. 1986).

²⁸ *Id.*

the substantial effect requirement.²⁹ However, the Anti-Terrorism Act (“ATA”) specifically prohibits the provision of material support or resources to terrorist organizations, including currency, monetary instruments, financial securities, and financial services.³⁰ (See section II(A)(3) below for a broader discussion on ATCA.)

Liability will ensue if the defendant bank provided such resources knowing or intending that they are to be used in preparation for, or in carrying out, terrorist activities.³¹ The knowledge requirement is satisfied by the defendant’s actual knowledge of a group’s activities. It can also be established if the defendant was “deliberately indifferent” to whether the group engages in terrorist activities, meaning that the defendant failed to act on and ignored such facts that put him on notice of substantial probability of terrorist activities.³² Additionally, US courts have referred to the possible imposition of liability if a bank maintains accounts for a charity which provides funding to an organization designated as a terrorist organization.³³

2. Lender Liability for Environmental Harm

In the last years of the nineteenth century, an American industrialist named Willian T. Love dug a canal between the upper and lower Niagara rivers.³⁴ He envisioned the construction of a dam which would power a nearby model community he hoped to build. But when the economy fluctuated, Love’s funding dried up and he abandoned the project, leaving a ditch where the canal was to run. Love sold the land at auction in 1920, after which it became a dumping ground for hazardous chemical waste.³⁵ By 1952, thirty years after it was sold, the companies Hooker Chemicals and Plastics Corporation had disposed of approximately 22,000 tons of chemical wastes in the then abandoned ditch.³⁶ Thereafter, Hooker Chemicals filled in the ditch with soil and sold the property to the Niagara Falls community.³⁷ The sale price was one dollar.³⁸

Years later, in 1977, Love Canal residents reported an unusual number of miscarriages and children born with birth defects.³⁹ As the irregularities mounted, the Love Canal story became widely publicized, and inspired public outrage.⁴⁰ A visit to the site by then-President Carter resulted in it being declared an environmental emergency, the first man-made emergency of its

²⁹ See Team 1 memo, supra note 11, for more details on aiding and abetting analysis under ATCA.

³⁰ 18 U.S.C. § 2339.

³¹ *Id.*

³² *Weiss v. National Westminster Bank PLC*, 768 F.3d 202 (2d Cir. 2014); *Strauss v. Credit Lyonnais, S.A.*, 925 F. Supp. 2d 414, 428–29 (E.D. N.Y. 2013).

³³ *Weiss*, 768 F.3d 209.

³⁴ <https://heinonline.org/HOL/LandingPage?handle=hein.journals/epajrnl5&div=10&id=&page=>

³⁵ The Catastrophe Model of Risk Regulation and the Regulatory Legacy of Three Mile Island and Love Canal, 15 Penn St. Envtl. L. Rev. 463, 473.

³⁶ The Catastrophe Model of Risk Regulation and the Regulatory Legacy of Three Mile Island and Love Canal, 15 Penn St. Envtl. L. Rev. 463, 473.

³⁷ The Catastrophe Model of Risk Regulation and the Regulatory Legacy of Three Mile Island and Love Canal, 15 Penn St. Envtl. L. Rev. 463, 473.

³⁸ The Catastrophe Model of Risk Regulation and the Regulatory Legacy of Three Mile Island and Love Canal, 15 Penn St. Envtl. L. Rev. 463, 473.

³⁹ <https://heinonline.org/HOL/LandingPage?handle=hein.journals/epajrnl5&div=10&id=&page=>

⁴⁰ <https://heinonline.org/HOL/LandingPage?handle=hein.journals/epajrnl5&div=10&id=&page=>

kind.⁴¹ Ultimately, as many as one thousand families were forced to relocate from Love Canal and the surrounding area, and hundreds of millions of dollars were spent in remediation and property damage.⁴² The Love Canal disaster, and others like it, brought attention to the risks of environmental harm caused by hazardous waste mismanagement. In response, Congress was spurred to enact a comprehensive measure to deal with and prevent such incidents.⁴³ Three years after the Love Canal incident, Congress passed CERCLA.⁴⁴

a) The Comprehensive Environmental Response, Compensation, and Liability Act

CERCLA, passed by congress in 1980, authorizes the Environmental Protection Agency (“EPA”) to investigate and clean up large contamination sites (known as Superfund sites), and enables the agency to compel responsible parties to pay.⁴⁵ Under CERCLA, EPA could either choose “enforcement first” i.e. requiring liable parties to conduct hazardous site cleanup, or could conduct the cleanup itself using money from a Superfund created under the law for this express purpose, and then bring suit against liable parties to recoup the cost.⁴⁶

(1) Liable parties under CERCLA

Under CERCLA, certain parties can be held liable for cleanup costs. These parties include: “(1) “the current owner and operator [of a contamination cite]; (2) any owner or operator at the time of disposal of any hazardous substances; (3) any person who arranged for the disposal or treatment of hazardous substances, or arranged for the transportation of hazardous substances for disposal or treatment; and (4) any person who accepts hazardous substances for transport to the site and selects the site.”⁴⁷

Section 101(20)(A) of CERCLA defines an “owner or operator” as any person who: “(1) owns or operates that onshore or offshore facility; or (2) owned, operated or otherwise controlled activities at that facility immediately before title to the facility, or control of the facility, was conveyed to a unit of state or local government due to bankruptcy, foreclosure, tax delinquency, abandonment or similar means.”⁴⁸ These definitions of ownership implicate lenders who, for example, hold ownership in a CERCLA facility primarily to protect their security interest in that facility. (As such, this form of lender liability falls under the theory of control liability discussed in *Section II(A)(1)* above.) However, this avenue for lender liability is largely precluded by an explicit secured creditor exemption discussed in *Section 2(A)(4)*.

⁴¹ The Catastrophe Model of Risk Regulation and the Regulatory Legacy of Three Mile Island and Love Canal, 15 Penn St. Envtl. L. Rev. 463, 473

⁴² The Catastrophe Model of Risk Regulation and the Regulatory Legacy of Three Mile Island and Love Canal, 15 Penn St. Envtl. L. Rev. 463, 473.

⁴³ <https://web.archive.org/web/20100909035122/http://www.epa.gov/superfund/20years/ch3pg1.htm>

⁴⁴ <https://web.archive.org/web/20100909035122/http://www.epa.gov/superfund/20years/ch3pg1.htm>

⁴⁵ Land pollution, environmental risks and bank lending: An empirical analysis ELR 17 4 (237)

⁴⁶ <https://www.epa.gov/sites/production/files/documents/lender-liab-07-fs.pdf>

⁴⁷ <https://www.epa.gov/sites/production/files/documents/lender-liab-07-fs.pdf>

⁴⁸ <https://www.epa.gov/sites/production/files/documents/lender-liab-07-fs.pdf>

(2) *Types of liability under CERCLA*

CERCLA primarily entails civil liability.⁴⁹ A responsible party can be found liable for cleanup costs, damages to natural resources, the costs of health assessments, and injunctive relief.⁵⁰ Additionally some punitive damages may be assessed on the responsible parties according to an annually adjusted EPA guidance.⁵¹ The 2020 guidance raised the maximum daily CERCLA penalty to \$58,328.

Responsible parties may under certain circumstances face criminal liability as well.⁵² A person in charge of a facility or vessel can face criminal charges if they knowingly “[fail] to notify the appropriate agency of the U.S. Government immediately as soon as he/she became aware of the release into the environment of a hazardous substance in an amount equal to or greater than a reportable quantity without a federal permit.”⁵³ Responsible parties could face up to three years of imprisonment and/or fines, and second offenders could face five years imprisonment.⁵⁴

(3) *Standard of Liability under CERCLA*

Although there is no explicit reference to a standard of liability under CERCLA, CERCLA defines liability by reference to the Clean Water Act.⁵⁵ Actions brought under the Clean Water Act have established a strict liability scheme, which has been imposed by courts in CERCLA cases.⁵⁶

(4) *Lender Liability under CERCLA: The Secured Creditor Exemption*

While CERCLA’s definition of ownership on its face might give rise to lender liability, CERCLA contains a “secured creditor exemption.”⁵⁷ Section 101(20)(A) of CERCLA explicitly excludes any “person, who, without participating in the management of a . . . facility, holds indicia of ownership primarily to protect his security interest in the . . . facility.” I.e. under CERCLA, a lender who merely holds ownership to secure their financial interest cannot be held liable.⁵⁸ However, what exactly “participating in management” means – and what types of activities it encompasses – has been a contentious question over the course of CERCLA’s history.

⁴⁹ [https://www.marlazidelaw.com/newsletters/criminal-liability-under-the-comprehensive-environmental-response-compensation-and-liability-act/#:~:text=Under%20the%20Comprehensive%20Environmental%20Response%2C%20Compensation%2C%20and%20Liability%20Act%20\(charges%20under%20CERCLA%20do%20exist.](https://www.marlazidelaw.com/newsletters/criminal-liability-under-the-comprehensive-environmental-response-compensation-and-liability-act/#:~:text=Under%20the%20Comprehensive%20Environmental%20Response%2C%20Compensation%2C%20and%20Liability%20Act%20(charges%20under%20CERCLA%20do%20exist.)

⁵⁰ <https://www.epa.gov/enforcement/superfund-liability>

⁵¹ <https://www.epa.gov/enforcement/guidance-penalty-matrix-cercla-section-106b1-civil-penalty-policy>

⁵² <https://www.epa.gov/enforcement/criminal-provisions-comprehensive-environmental-response-compensation-and-liability-act>

⁵³ <https://www.epa.gov/enforcement/criminal-provisions-comprehensive-environmental-response-compensation-and-liability-act>

⁵⁴ <https://www.epa.gov/enforcement/criminal-provisions-comprehensive-environmental-response-compensation-and-liability-act>

⁵⁵ See 42 U.S.C. 9601(32) (1988).

⁵⁶ <https://ir.law.fsu.edu/cgi/viewcontent.cgi?article=1094&context=jluel>

⁵⁷ <https://www.epa.gov/sites/production/files/documents/lender-liab-07-fs.pdf>

⁵⁸ <https://www.epa.gov/sites/production/files/documents/lender-liab-07-fs.pdf>

(5) *Evolution of CERCLA ‘Participating in Management’ Standard for Lender Liability Secured Creditor Exemption*

The current interpretation of lender liability and the secured creditor exemption under CERCLA was built over the course of a number of court decisions and amendments. Tracing CERCLA’s development over the years since its passage can help to better understand its current status, and the extent to which investors can expect to face liability for their actions.

- ***US v. Mirabile (1985)***

One of the earliest U.S. decisions on lender liability post CERCLA was *US v. Mirabile*.⁵⁹ The EPA sued the Defendants to recoup costs incurred in the cleanup of hazardous waste at a paint manufacturing site that the Defendants had acquired. The Defendants in turn joined American Bank and Trust Company (“ABT”) and Mellon Bank, to the lawsuit, arguing that actions taken by the banks in the intermediate period between the foreclosure of the property and the acquisition by the Defendants fell outside of the “Secured Creditor” exemption in CERCLA.⁶⁰ During that period, ABT had “secured the building against vandalism,” “made inquiries as to the approximate cost of disposal of various drums located on the property,” and, “visited the property ... for the purpose of showing it to prospective purchasers.”⁶¹

The *Mirabile* court ruled that “before a secured creditor such as ABT may be held liable, it must, at a minimum, participate in the day-to-day operational aspects of the site. In the instant case, ABT merely foreclosed on the property after all operations had ceased and thereafter took prudent and routine steps to secure the property against further depreciation.”⁶²

- ***Guidice v. BFG Electroplating & Manufacturing Co. (1989)***

The “day-to-day” operations standard cited in *Mirabile* was upheld in the 1989 decision *Guidice v. BFG Electroplating & Manufacturing Co.*⁶³ In *Guidice*, the court ruled that National Bank of Commonwealth’s actions towards a foreclosed treatment facility did not meet the operational requirements of CERCLA. The bank’s activities included “receipt of financial statements, meetings with the defaulting borrower, visits to the facility, and referral of a potential lessee to the borrower’s attorney.”⁶⁴ The court supported its decision with a policy consideration, arguing that to hold a lender liable for its attempts to help a debtor handle its own hazardous waste would

⁵⁹ *United States v. Mirabile*, No. 84-2280 (E.D. Pa. September 4, 1985)

⁶⁰ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁶¹ *United States v. Mirabile*, No. 84-2280 (E.D. Pa. September 4, 1985)

⁶² *United States v. Mirabile*, No. 84-2280 (E.D. Pa. September 4, 1985)

⁶³ *Guidice v. BFG Electroplating & Manufacturing Co.*, 732 F. Supp. 556 (W.D. Pa. 1989).

⁶⁴ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

discourage lenders from offering assistance, and undermine CERCLA's ultimate goal of preventing future hazardous waste incidents.⁶⁵

The policy rationale articulated here in Guidice would seem relevant to any proposed expansion of lender liability for MDBs, which, despite being mission-driven public organizations, are also motivated by some of the same incentives and risks as domestic private banks.

- ***US v. Fleet Factors Corporation (1990)***

The standard set up by the *Mirabile* line of cases, that a lender must participate in day-to-day operations of a facility before losing its secured creditor protection, was overturned in *US v. Fleet Factors Corporation*.⁶⁶ In *Fleet Factors*, a cloth-printing facility borrowed money from Fleet Factors, a commercial lender. As part of the transaction, Fleet Factors took a security interest in the borrower's equipment, inventory, and property, and was frequently in contact with the borrower's financial office.⁶⁷ After the borrower filed for bankruptcy, Fleet Factors continued to advance funding up until it exhausted the value of its collateral.⁶⁸ Fleet Factors then foreclosed on its security interest on the equipment and inventory, but not the property.⁶⁹ After the foreclosure, the EPA discovered 700 drums of toxic chemicals and asbestos, and initiated an action against Fleet Factors under CERCLA to recoup the cost of cleaning the site.⁷⁰

While the district court followed *Mirabile*, exempting Fleet Factors activities as not meeting the operational standard under CERCLA, the Eleventh Circuit Court of Appeals discarded the *Mirabile* standard.⁷¹ The court ruled that day-to-day involvement was not in fact required to meet the CERCLA "participation in management" standard.⁷² Instead, the court adopted a new liability standard finding that lenders who participate in "financial management of a facility to a degree indicating a capacity to influence the corporation's treatment of hazardous wastes" can in fact be found liable under CERCLA.⁷³ Further, the court ruled that even if a lender does not actively participate in decisions regarding hazardous waste, if its involvement with management of the facility was such that it *could* have affected hazardous waste decisions, it cannot assert the secured creditor exemption.⁷⁴ Defendants appealed the decision, but the Supreme Court denied certification, lending credence to the Appellate decision.⁷⁵

Once again, it is easy to imagine a similar policy rationale being applicable to the situation of multilateral development banks. MDBs are usually influential partners in the financing relationship with the client and hence will often have capacity to influence borrowers. A capacity standard of this kind could conceivably disincentivize development banks from exercising their

⁶⁵ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁶⁶ *United States v. Fleet Factors Corp.*, 901 F.2d 1550, 1552 (11th Cir. 1990)

⁶⁷ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁶⁸ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁶⁹ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁷⁰ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁷¹ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁷² Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁷³ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁷⁴ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁷⁵ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

existing oversight abilities for fear of crossing a *Fleet Factors*-type threshold, and could conversely lead to adverse environmental outcomes. Ultimately, a less demanding standard of the *Mirabile* kind might allow development banks to implement stronger due diligence frameworks without risking liability.

- ***In re Bergsoe Metal Corp. (1990)***

The *Fleet Factors* decision, itself overturning prior judicial precedent, was challenged shortly thereafter in *In re Bergsoe Metal Corp.*⁷⁶ *Bergsoe* dealt with a complex fact pattern in which the Port of St. Helens issued revenue bonds to promote industrial development in the surrounding area.⁷⁷ In this capacity, it financed the construction of a recycling plant by Bergsoe Metal Corp.⁷⁸ As part of the transaction, the Port purchased land from Bergsoe, and then leased it and the plant back to Bergsoe.⁷⁹ The Port then mortgaged the property and plant to the National Bank of Oregon, assigning all of its rights under the lease to the bank.⁸⁰ After Bergsoe defaulted on its payments, it was placed into involuntary bankruptcy, and Oregon state found that the site was contaminated.⁸¹

The Port argued it was protected by the secured creditor exemption, and therefore not liable.⁸² The Court sided with the Port, ruling that it held title to the property merely to ensure payment on the lease.⁸³ The Court cited *Fleet Factors*, but ultimately ruled that ***the mere capacity to participate in management was not the standard, but rather the question was if the Port had indeed participated in management.***⁸⁴

- ***1992 Amended EPA Rule***

In the wake of *Fleet Factors* and *Bergsoe*, the status of lender liability under CERCLA was uncertain. This uncertainty led to a general reluctance among financial institutions to invest in projects.⁸⁵ In an attempt to settle the CERCLA confusion, the EPA issued its lender liability rule.⁸⁶ Under the EPA rule, a lender could maintain limited involvement with a CERCLA facility without losing the secured creditor exemption.⁸⁷ A lender only activated CERCLA liability if it actually was involved in “hazardous-waste decisionmaking, environmental compliance or substantial day-to-day managerial control over the site.” Additionally, the secured creditor exemption was extended to protect lenders that had become owners of contaminated sites via foreclosure proceedings, as long as the lender made “commercially reasonable efforts” to sell the property after foreclosure.

⁷⁶ *In re Bergsoe Metal Corp.*, 910 F.2d 668 (9th Cir. 1990).

⁷⁷ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁷⁸ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁷⁹ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁸⁰ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁸¹ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁸² Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁸³ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁸⁴ Lender Liability Under CERCLA: Sorting out the Mixed Signals, 64 S. Cal. L. Rev. 1187

⁸⁵ J. Jarvis and M. Fordham, *Lender Liability: Environmental Risk and Debt* (Cameron May: London, 1993) 16 ELR 17 4 (237).

⁸⁶ 57 Fed. Reg. 19344 (Apr. 29, 1992), codified at 40 C.F.R. § 300.1100 (1992).

⁸⁷ 3 Treatise on Environmental Law § 4A.02 (2020)

While this did temporarily clarify the inherent contradiction between *Fleet Factors* and *In re Bergsoe*, this EPA rule was struck down by the D.C. Circuit in *Kelley v. EPA*, in which the court held that this interpretation went beyond the EPA's rulemaking authority.⁸⁸

- ***1996 Asset Conservation, Lender Liability, and Deposit Insurance Protection Act Amendments***

After the EPA's 1992 rule was struck down, pressure mounted on Congress to clarify lender liability issues under CERCLA.⁸⁹ In 1996, Congress responded by passing an amendment to clarify lender liability, and put the preceding decade-long dispute to rest.⁹⁰ ***The Asset Conservation, Lender Liability, and Deposit Insurance Protection Act Amendments ("ACA") settled lender liability under CERCLA, and remains the standard under which lender liability is assessed, as outlined below.***

(6) *Current Interpretation of Lender Liability and the Secured Creditor Exemption under CERCLA/ACA*

The current rules on lender liability under CERCLA are a far cry from the broader, "capacity to influence" lender liability standard envisioned by the *Fleet Factors* court. ***"Participating in Management" has been more narrowly defined, and precludes lender liability for a number of investor activities that might have triggered liability under Fleet Factors.***

- ***Activities which constitute participation in management under CERCLA/ACA***⁹¹

A lender participates in management, and therefore forfeits the secured creditor exemption, if the investor (while the borrower is still in possession of the facility):

- Exercises decision-making control regarding environmental compliance related to the facility and, in doing so, undertakes responsibility for hazardous substance handling or disposal practices; or
- Exercises control at a level similar to that of a manager of the facility and, in doing so, assumes or manifests responsibility with respect to:
 - day-to-day decision-making on environmental compliance, or
 - all, or substantially all, of the operational (as opposed to financial or administrative) functions of the facility other than environmental compliance.

In the event of foreclosure in which the investor takes title to the contaminated property, an investor which did not previously participate in management (as defined above) may without forfeiting the secured creditor exemption:

- Maintain business activities;
- Wind up operations;
- Undertake a response action under CERCLA Section 107(d)(1) or under the direction of an on-scene coordinator;
- Sell, re-lease or liquidate the facility; or
- Take actions to preserve, protect or prepare the property for sale.

⁸⁸ *Kelley v. EPA*, 15 F.3d 1100 (D.C. Cir.), reh'g denied, 25 F.3d 1088 (D.C. Cir. 1994), cert. denied sub nom. *American Bankers Ass'n v. Kelley*, 513 U.S. 1110, 115 S. Ct. 900, 130 L. Ed. 2d 784 (1995).

⁸⁹ 3Treatise on Environmental Law § 4A.02 (2020)

⁹⁰ 3Treatise on Environmental Law § 4A.02 (2020)

⁹¹ <https://www.epa.gov/sites/production/files/documents/lender-liab-07-fs.pdf>

Provided that the lender attempts to sell or re-lease the property held pursuant to a sale or lease financing transaction, or otherwise divest itself of the property at the earliest practicable, commercially reasonable time using commercially reasonable means.

- ***Activities which do not constitute participation in management under CERCLA/ACA***⁹²

Participation in management does not include:

- Merely having the capacity to influence or the unexercised right to control facility operations;
- Performing an act or failing to act prior to the time at which a security interest is created in a facility;
- Holding a security interest or abandoning or releasing a security interest;
- Including in the terms of an extension of credit, or in a contract or security agreement relating to the extension, a covenant, warranty or other term or condition that relates to environmental compliance;
- Monitoring or enforcing the terms and conditions of the extension of credit or security interest
- Monitoring or inspecting the facility;
- Requiring a response action in connection with a release or threatened release of a hazardous substance;
- Providing financial or other advice to the borrower in an effort to mitigate, prevent or cure default or diminution in the value of the facility;
- Restructuring the terms and conditions of the extension of credit or security interest, or exercising forbearance;
- Exercising other remedies for the breach of the extension of credit or security agreement; or
- Conducting a response action under CERCLA or under the National Contingency Plan, provided that these actions do not rise to the level of participation in management within the meaning of the statute.

(7) Backstop to Lender Liability: The Landowner Liability Defense

Lenders that do cross the threshold under CERCLA/ACA for forfeiting the secured creditor exemption may have available to them one additional defense, the Landowner Liability Defense.⁹³ In 2002, Congress enacted the Small Business Liability Relief and Brownfields Revitalization Act, 115 Stat. 2356, in which it further clarified liability defenses under CERCLA, known as Landowner Liability Protections.⁹⁴

There are three defenses which fall under these Landowner Liability Protections: the Bona Fide Prospective Purchaser defense, the Contiguous Property Owner defense, and the Innocent Landowner defense.⁹⁵ While each differs as to the context in which a contaminated property is acquired, they each state that the acquirer must have conducted “all appropriate inquiries” (“AAI”)

⁹² <https://www.epa.gov/sites/production/files/documents/lender-liab-07-fs.pdf>

⁹³ 1 LENDER LIABILITY LAW AND LITIGATION § 12.05 (2020)

⁹⁴ *Id.*

⁹⁵ *Id.*

prior to taking title in order to raise this defense.⁹⁶ EPA has defined AAI as conducting a “Phase I Environmental Site Assessment” in accordance with American Society for Testing and Materials (“ASTM”) standard practice.⁹⁷ This ASTM Phase I assessment includes: “(i) interviews with owners, operators, and occupants; (ii) searches for recorded environmental cleanup liens; (iii) reviews of federal, tribal, state, and local government records; (iv) visual inspections of the property and of adjoining properties; and (v) the declaration by the environmental professional responsible for the assessment or update.”⁹⁸

While this defense of “all appropriate inquiries” would only cover lenders who actually foreclose on a property, it explicitly contemplates or incentivizes due diligence, and suggests a relationship between the availability of a defense to liability and appropriate due diligence.

(8) *Navigating Lender Liability under CERCLA/ACA*

While the final interpretation of CERCLA under ACA broadly bars lender liability, there are still instances in which a lender could forfeit their secured creditor exemption (and would then need to appeal to the Landowner Liability defenses). Analysts have therefore laid out steps analysts that a lender can take to mitigate the remaining risk of activating lender liability.⁹⁹ These actions include:

- **Avoiding Deeds of Trust** – while perhaps impractical, lenders can better avoid the question of liability by issuing unsecured loans, or loans secured only by liens on equipment, inventory, and accounts receivable, and not real property owned by the borrower.¹⁰⁰ While CERCLA offers broad protection from liability even for those that do take a security interest in real property, the issue would be skirted entirely in the absence of that security interest.¹⁰¹ However, even lenders that limit their security interest to equipment or inventory can be found liable if the lender creates or exacerbates an already existing environmental problem in the property in which the inventory or equipment is found.¹⁰²
- **Establish Environmental Policies and Operating Practices**
 - **Policies** – According to a 2008 survey, 94% of banks have instituted formal environmental risk policies, and many have heightened levels of environmental due diligence.¹⁰³ These policies should include all stages of the loan process including the: application phase, loan documentation phase, loan policing/workout phase, and the foreclosure / sale of collateral phase.¹⁰⁴
 - **Operating Practices** – Lenders should investigate environmental matters relating to the borrower, including its operations and property, whether or not that property

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ <https://www.astm.org/Standards/E1527.htm>

⁹⁹ 1 Lender Liability Law and Litigation § 12.07 Strategies for Avoiding Lender Liability Under Environmental Law (2020)

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

is being provided as collateral for the loan.¹⁰⁵ Lenders should require borrowers to complete an environmental questionnaire, similar to or expanding on the American Society for Testing and Materials (“ASTM”) standard.^{106 107} If any evidence of contamination (or a likely source of contamination) is discovered, the lender should request an investigation, and estimate the remediation costs of any risks found.¹⁰⁸ Depending on the size of the risk, the lender should evaluate the financial ability of the borrower to assess its ability to cover the remediation costs.¹⁰⁹

- **Establish Loan Criteria** – The lender may wish to implement loan criteria that take into account environmental risk.¹¹⁰
- **Conduct Monitoring/Policing Actions** – Monitoring actions allowed under CERCLA / relevant case law include:¹¹¹
 - a. requiring that borrower clean up real property;
 - b. requiring borrower compliance with environmental laws and regulations;
 - c. monitoring borrower’s business/financial condition;
 - d. requiring borrower’s compliance with representations and warranties;
 - e. lender’s exercise of rights pursuant to covenants, representations, and warranties in the loan documents;
 - f. requiring borrower to perform an environmental audit and to comply with the recommendations in the audit; and
 - g. providing financial or other advice, suggestions, counsel, or guidance.

Operating practices however should not provide for the lender to clean up contamination directly, or tell the borrower how to clean up the property, which might indicate lender’s control over the borrower’s environmental compliance and day-to-day operations.¹¹²

- **Foreclosure/Sale of Collateral Procedures** – Lenders can foreclose without risking their secured creditor exemption.¹¹³ Lender should not, however, take actions that would interact with or exacerbate existing environmental contamination sources.¹¹⁴ The lender should also act to promptly sell the foreclosed property, and take the following actions to maintain the secured creditor exemption:

“(i) act to sell or divest the property promptly upon foreclosure; and (ii) use commercially reasonable means for sale or divestiture; or (iii) list the property as being for sale within 12 months of lender having legal right to

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ https://www.partneresi.com/sites/default/files/partner_aai_user_phase_i_questionnaire.pdf

¹⁰⁸ 1 Lender Liability Law and Litigation § 12.07 Strategies for Avoiding Lender Liability Under Environmental Law (2020)

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.*

sell the property (lender must act diligently to acquire market title following foreclosure); and (iv) if purchased at foreclosure, not reject or outbid any offer that is equal to or exceeds the debt owed by the borrower; and (v) any time after six months following foreclosure, accept (i.e., not reject or outbid) any written, bona fide (cash) offer within 90 days of receipt.”¹¹⁵

(9) *Environmental Due Diligence and Lender Liability*

The text of CERCLA does not strictly obligate lenders to perform due diligence to avail themselves of the secured creditor exemption to liability. In fact, as discussed above, the EPA lays out a broad variety of due diligence activities lenders can undertake without being deemed to be “participating in management” in such a way as might attract liability.¹¹⁶ These include: including in the credit agreement/contract terms relating to environmental compliance; monitoring or enforcing the terms of the agreement; monitoring and inspecting the facility; requiring response actions in connection with a contamination; and providing financial or other advice to the borrower to mitigate, prevent or cure default or diminution in the value of the facility.¹¹⁷

Beyond this, there are instances in which lenders could forfeit the secured creditor exemption and need to appeal to the Landowner Liability Defenses. These lenders would then need to demonstrate that they conducted AAI regarding the acquired CERCLA site, in order to avail themselves of the Landowner Liability Defenses. AAI includes conducting an ASTM Phase I assessment of the facility, which itself consists of due diligence-type activities.

This two-layered approach may hold relevant lessons for Multilateral Development Banks due diligence. First: the “ASTM” assessment standard discussed above is in effect a formalized instance of due diligence in U.S. Environmental Law, (albeit one that is utilized in the specific context of lender foreclosure on a contamination site). Secondly, US environmental law sets a very high bar for lenders to forfeit the secured creditor exemption. This high bar should help to alleviate concerns sometimes expressed by development banks that carrying out due diligence may increase their own legal liability exposure.

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(10) *General conclusions on U.S. Lender Liability for Environmental Harms*

Lender Liability in the U.S. for environmental harms is broadly circumscribed under the “secured creditor exemption” of CERCLA and its later amendments. While the case law on CERCLA did at once contemplate broader lender liability under *Fleet Factors* by re-defining CERCLA’s “participation in management” standard to a “capacity to influence” standard, this was overturned both by later litigation as well as Congressional action.

The current status of CERCLA bars lender liability except in instances where the lender actually exercises decision-making control regarding environmental compliance such that they undertake responsibility for hazardous substance handling or disposal, or exercises managerial

¹¹⁵ *Id.*

¹¹⁶ ARTICLE: LENDER LIABILITY UNDER CERCLA: SORTING OUT THE MIXED SIGNALS., 64 S. Cal. L. Rev. 1187, 1208

¹¹⁷ <https://www.epa.gov/sites/production/files/documents/lender-liab-07-fs.pdf>.

control of the facility and assumes responsibility regarding the day-to-day decision-making. Furthermore, even lenders which due forfeit their secured creditor exemption can appeal to the Landowner Liability Defenses, so long as they conducted AAI.

For these reasons, the current law both makes it difficult to impose liability on financial institutions, and simultaneously allows these institutions to implement a broad range of precautionary measures and policies with significant potential environmental impact, without sacrificing their liability shield. This suggests that broader due diligence can be undertaken by MDBs without thereby incurring any risk of legal liability.

3. *Lender Liability for Social Harm*

a) *Introduction*

This section examines the potential legal avenues in the U.S. through which victims of human rights violations might bring claims against banks, and discusses the associated legal standards. It is worth noting that the discussion of lender liability for social harm almost exclusively occurs within the broader context of corporate liability.¹¹⁸ As will be made evident from the case law discussed below, courts do not seem to draw a distinction between commercial banks and other types of corporations. In other words, commercial banks are dealt with primarily as a type of corporation that provides funding to borrowers.

The Alien Tort Claims Act (ATCA) and the Torture Victim Protection Act are the main legal vehicles through which victims of human rights abuse can seek compensation.¹¹⁹ However, it is extremely difficult to hold banks liable under these provisions for lending money to borrowers that result in human rights violations. In addition, the practice of due diligence by banks is unlikely to expose them to lender liability for the social harms caused by their borrowers.

b) *The Alien Tort Claims Act*

(1) *Overview*

Suits for corporate liability for human rights violations have been brought before U.S. courts primarily under ATCA.¹²⁰ As part of the First Judiciary Act, ATCA was passed during the first session of Congress in 1789 and “authorized civil lawsuits for money damages for those injured by violations of international law.”¹²¹ It gives federal courts jurisdiction over non-citizens for torts that were “committed in violation of the law of nations or a treaty of the United States.”¹²²

ATCA remained dormant for almost 200 years until the Second Circuit’s decision in *Filartiga v. Pena-Irala*, in which the court recognized international human rights as part of U.S. common law, and used ATCA as a means to hold human rights abusers liable.¹²³ Since then, ATCA has been regularly invoked by non-U.S. plaintiffs seeking to address human rights violations committed abroad, and the case law has gradually developed as what harms are covered and what the standard of liability is.

¹¹⁸ See, e.g., Elizabeth T. Reichard, *Catching the Money Train: Using the Alien Tort Claims Act to Hold Private Banks Liable for Human Rights Abuses*, 36 Case W. Res. J. Int’l L. 255, 258 (2004).

¹¹⁹ See *Developments in the Law—Corporate Liability for Violations of International Human Rights Law*, 114 HARV. L. REV. 2030-2031 (2001).

¹²⁰ Michalowski, *supra* note 87, 453.

¹²¹ Brad J. Kieserman, *Profits and Principles: Promoting Multinational Corporate Responsibility by Amending the Tort Claims Act*, Comment, 48 CATH. U. L. REV. 881, 890-891 (1999); Beth Stephens, *Corporate Accountability: International Human Rights Litigation Against Corporations in US Courts*, in *LIABILITY OF MULTINATIONAL CORPORATIONS UNDER INTERNATIONAL LAW* 209, 210-11 (Menno T. Kamminga & Saman Zia-Zarifi eds., 2000).

¹²² 28 U.S.C.A. §1350 (2002).

¹²³ Reichard, *supra* note 100, 264.

In the following section the standard of liability under ATCA will first be discussed, followed by analysis of recent developments that have limited the liability of lenders for loans made to human rights abusers under ATCA.

(2) *Theories of Liability*

- ***Aiding and Abetting a Government's Human Rights Violations***

On the aiding and abetting theory discussed above, a lender could potentially be found liable under ATCA as a kind of accessory to a government's human rights violation. The US Courts, however, have struggled with the requisite standard of *actus reus* and *mens rea* in such instances. While there is broadly agreement among courts that aiding and abetting liability can exist under ATCA and is recognized by international law, there is a division of opinion as to which legal standard should be applied in assessing such liability.¹²⁴

Aiding and abetting liability is well-established in criminal law and tort law. Although it is rooted in criminal law, it is also a form of liability recognize in tort law and international law.¹²⁵ Aiding and abetting under ATCA is particularly complex because it “involves a federal tort remedy for breaches of international human rights principles, which generally involve criminal law.”¹²⁶ In other words, while ATCA claims are tort claims under the statute, the standard of liability utilized in relation to certain kinds of international law violations (and, specifically, for aiding and abetting an international legal violation) tends to be rooted in criminal law, and courts often consult international criminal cases to determine the relevant standard.

- ***Actus Reus***

In *Doe I v. Unocal Corporations*, the court held that the requisite *actus reus* standard for aiding and abetting liability under ACTA is “practical assistance or encouragement”.¹²⁷ This standard has been further elaborated in the case of *African Apartheid Litigation*, in which the court held that “the *actus reus* of aiding and abetting in international criminal law requires practical assistance, encouragement, or moral support which has a *substantial effect* on the perpetration of the crime.”¹²⁸ Regarding the question of what sort of action amounts to having a substantial effect on the commission of gross human rights violations, the court highlighted the difference between simply aiding a criminal, and aiding and abetting the criminal's human rights abuses.¹²⁹ Liability will follow from aiding and abetting the violations committed by a government actor or regime, and not from merely doing business with the regime or from aiding the regime itself.¹³⁰

In formulating a definition for “substantial effect”, the court compared two Nuremberg cases and emphasized the nature of the ‘aiding and abetting’ activity in question. In the *Ministries Case*, the Nuremberg Tribunal rejected the liability of the banks as it did not regard the bank's activities as

¹²⁴ 59 Boston College Law Review 2953, 2966. Srish Khakurel, The Circuit Split on Mens Rea for Aiding and Abetting Liability Under the Alien Tort Statute, 59 B.C.L. Rev. 2953, 2966 (2018).

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Doe I*, 395 F.3d at 937.

¹²⁸ *In re South African Apartheid*, 617 F. Supp. 2d at 257.

¹²⁹ *Id.*

¹³⁰ *See also, Khulumani*, 504 F.3d at 289 (Hall, J., concurring).

criminal: “Loans or sale of commodities to be used in an unlawful enterprise may well be condemned from a moral standpoint and reflect no credit on the part of the lender or seller in either case, but the transaction can hardly be said to be a crime.”¹³¹ In contrast, in the *Zyklon B Case*, the defendant, whose factory had manufactured and sold the legal gas used by Germany in its concentration camps during the Holocaust, was found guilty of aiding and abetting crimes against humanity for supplying the gas used in the execution of allied nationals.¹³²

In the *Zyklon B Case*, the court highlighted the inherent difference between money as “a fungible resource” and poison gas as “a killing agent”: “The provision of goods specifically designed to kill, to inflict pain, or to cause other injuries resulting from violations of customary international law bear a closer causal connection to the principal crime than the sale of raw materials or the provision of loans.”¹³³ The court came to the conclusion that, “in the context of commercial services, provision of the means by which a violation of the law is carried out is sufficient to meet the *actus reus* requirement of aiding and abetting liability under customary international law.”¹³⁴ However, given that money can never be “the direct means through which international human rights violations occur,” the provision of a commercial loan cannot meet the *actus reus* test, regardless of its effect on the commission of offences.¹³⁵

In summary, the *actus reus* of accessory liability for the provision of commercial goods and services depends on two factors: (1) whether the goods were inherently dangerous or neutral, and (2) whether they were the direct means through which the crimes were committed. For goods which are inherently neutral, and by their very nature, be the instrument with which violation are carried out, the court excluded their provision as too remote from the commission of the principal offense.

Hence while the provision of funds alone is not sufficient to meet the actus reus of aiding and abetting liability under ACTA, the courts have not provided much guidance on which, if any, types of service could be deemed inherently dangerous, or deemed to be a direct means through which international human rights abuses have occurred. As a result, multilateral development banks are unlikely to be subject to lender liability for the provisions of funds to governments that engage in human rights violation.

- ***Mens Rea***

As shown above, in the case of the supply of “inherently neutral” goods, including money, courts have ruled that *actus reus* of aiding and abetting liability will not be met and thus no *mens rea* analysis is necessary. However, since the exercise of due diligence may bring the existence of actual or potential human rights abuses by borrowers to the attention of a lender/development bank, a discussion of the requisite *mens rea* of aiding and abetting liability under ATCA may be useful.

¹³¹ *United States v. Von Weizsacker* (“The Ministries Case”), 14 T.W.C., at 622 (1950)).

¹³² *The Zyklon B Case* at 93-103.

¹³³ *In re South African Apartheid*, 617 F. Supp. 2d at 258.

¹³⁴ *Id.* at 259.

¹³⁵ 30 Berkeley J. Int'l L. 451 Michalowski, *supra* note 87, 460.

Currently, the US circuit courts disagree as to the necessary *mens rea* for an ATCA claim on the basis of aiding and abetting liability. The Ninth Circuit first held that ATCA aiding and abetting liability required a *mens rea* of knowledge, according to which the defendant bank "knew or had reason to know that the [borrower principal] had the intent to commit the offense."¹³⁶ Following this standard the D.C. Circuit that ruled in *Doe VIII v. Exxon Mobil Corp.* that knowledge was sufficient, ruling that liability would attach if the defendant bank "ha[s] knowledge that his actions will assist the perpetrator in the commission of the crime".¹³⁷

However, the Second Circuit ruled that *purpose* would be required to fulfil the *mens rea*. In *Khulumani v. Barclay National Bank Ltd.*, the court stated that "a defendant is guilty of aiding and abetting the commission of a crime only if he does so [for] the purpose of facilitating the commission of such a crime."¹³⁸ The Fourth Circuit followed this rule in 2011 in *Aziz v. Alcolac, Inc.*, holding that purpose rather than knowledge was the appropriate standard.¹³⁹

Could the conduct of human rights due diligence by a bank be sufficient to support a finding of *mens rea* for aiding and abetting a human rights violation? This might in theory be possible, if mere knowledge would suffice (as some US courts have ruled) for the *mens rea*, so long as the *actus reus* of aiding and abetting had also been satisfied. In *Doe I*, for example, the court agreed with the lower court's finding that the defendant knew a human rights violation occurred.¹⁴⁰ In particular, the district court noted that the defendant "expressed concern that the Myanmar government was utilizing forced labor in connection with the Project" and concluded that "[the] evidence does suggest that Unocal knew that forced labor was being utilized and that the Joint Venturers benefitted from the practice".¹⁴¹ Thus the exercise of due diligence could potentially expose banks to lender liability if the due diligence effort revealed the borrower's human rights abuse in connection with the financed project, and the bank did nothing about this. On the other hand, other US courts have indicated that purpose is required to establish *mens rea*, and on this standard, a bank which conducts due diligence would not be at risk of being held liable for aiding and abetting a human rights violation, since the *mens rea* could not be satisfied by mere knowledge of a borrower's human rights violations.

Further, even for those courts which have specified that knowledge is sufficient to establish the requisite mens rea, banks that implement precautionary policies to detect risks of human rights abuse are not likely to face 'aiding and abetting' liability, because – as outlined in the previous section - the requisite actus reus is not established by mere lending.

- ***Joint Action with a State Actor***

Lender liability may also arise when lenders act jointly with the government in violating human rights. The court in *Doe v. Unocal Corp.* addressed the question of the possible liability under ACTA of private parties for human rights abuses that require state action.¹⁴² In particular, the

¹³⁶ *Doe I*, 395 F.3d at 951.

¹³⁷ *Doe VIII*, 654 F.3d 11, 34-39 (D.C. Cir. 2011).

¹³⁸ *Khulumani v. Barclay National Bank Ltd.*, 504 F.3d 254, 275 (2nd Cir. 2007).

¹³⁹ *Aziz v. Alcolac, Inc.*, 658 F.3d 388, 401 (4th Cir. 2011).

¹⁴⁰ *Doe I*, 395 F.3d at 953.

¹⁴¹ *Doe v. Unocal Corp.*, 110 F. Supp. 2d 1294, 1310 (C.D. Cal. 2000).

¹⁴² *Doe v. Unocal Corp.*, 110 F. Supp. 2d 1294 (C.D. Cal. 2000) [hereinafter *Unocal II*].

court relied on two tests under the “joint action” theory and discussed whether (1) the private actor conspired with the state actor in its commission of unlawful acts, and (2) the private actor participated in or influenced the state actor’s unlawful acts.¹⁴³

The court held that the mere fact that a private actor and public actor shared the goal of a profitable project did not establish joint action.¹⁴⁴ Instead, the shared goal must be specific such that the two actors had the shared goal of perpetuating the alleged offense.

In addition, the court suggested that a private project participant in a public participant’s violations of international law does not, without more, transform the private participant into a state actor.¹⁴⁵ Accordingly, the court rejected liability for the private actor despite Plaintiff’s evidence that the private actor had prior knowledge of the state actor’s history of human rights offenses, that the state actor would be providing security for the project, and that the state actor “committed, was committing, and would continue to commit” human rights abuses in relation to the project.¹⁴⁶ Although in the context of *Unocal II* the private parties were project sponsors and not lenders, this ruling nonetheless significantly restricted corporate liability. For this reason it seems unlikely that lenders would be exposed to liability where they had nothing more than mere knowledge of occurrence of a human rights violation.

The *Unocal II* court further held that a private actor will only be liable for the acts committed by a government if the plaintiffs prove that the private parties were the “proximate cause” of the violation.¹⁴⁷ The proof of proximate cause requires the plaintiff to show that the private actors controlled the state’s decision to commit the violation.¹⁴⁸

(3) *Recent Development on ATCA Case Law*

- ***Covered Harm***

While ATCA has been used as a means to try to hold corporations and banks accountable for human rights violations, case law has limited the extent to which it can be used to address harms that do not rise to the level of gross human rights violations.

In principle, ATCA covers violations of human rights recognized as part of international law. The *Filartiga* court first determined that the “law of the nations,” within the meaning of ATCA, means international law, which was adopted as part of federal common law and codified when ATCA granted federal courts jurisdictions over torts committed in violation of the “law of nations.”¹⁴⁹ The court also clarified the “law of nations” under ATCA means, holding that it is a body of law that evolves over time rather than being limited to the law of nations that existed in 1789 when ATCA was passed.¹⁵⁰ The reviewing court of each ATCA case is therefore required to consider

¹⁴³ *Id.* at 1307-07.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ Eric Marcks, Avoiding Liability for Human Rights Violations in Project Finance, 22 *EnergyENERGY L.J.* 301, 311. (2001).

¹⁴⁷ *Unocal II*, 110 F. Supp. 2d at 1307.

¹⁴⁸ *Id.*

¹⁴⁹ *Filartiga v. Pena-Irala*, 630 F.2d. 876, 878, 885 (2d Cir. 1980).

¹⁵⁰ *Id.* at 881, accord *Tel-Oren v. Libyan Arab Republic*, 726 F.2d 774, 789 (D.C. Cir. 1984).

the status of the “law of nations” as it is at the time of lawsuit.¹⁵¹ The relevant court should determine the status of the “law of nations” based on whether “the nations of the world have demonstrated that the wrong is of mutual, and not merely several, concern, by means of express international accords.”¹⁵² In making this determination, a court will look to the works of jurists, national practices and judicial decisions.¹⁵³ In particular, the *Filartiga* court determined that torture is a violation of the law of nations.¹⁵⁴

Later courts in adjudicating ATCA cases followed the approach of the *Filartiga* court to determine whether certain conduct is prohibited under international law and thus actionable under ATCA. *Tel-Oren v. Libyan Arab Republic* was one of the first cases to emerge after *Filartiga* and clarified the definition of the law of nations as including “a handful of heinous actions—each of which violates *definable, universal and obligatory norms*.”¹⁵⁵ The court in *Forti v. Suarez-Mason* followed this definition provided by the *Tel-Oren* court and held that disappearances are among the “universal, definable, and obligatory” norms prohibited under international law.¹⁵⁶ In reaching this conclusion, the court consulted UN General Assembly resolutions defining disappearance, the Universal Declaration of Human Rights, the International Covenant on Civil and Political Rights, and U.S. law.¹⁵⁷

The list of tortious conduct that violates the “law of nations” has been refined and elaborated by later courts adjudicating ATCA cases. The following crimes have been litigated under the ATCA and held to be violations of the law of nations: torture, extrajudicial executions and disappearances, arbitrary detention, genocide, war crimes, slavery, slave trading, and crimes against humanity.¹⁵⁸ Cruel, inhuman and degrading treatment, and a systematic pattern of violations have been deemed gross human rights violations, although not yet adjudicated under ATCA.¹⁵⁹ Other human rights violations such as environmental harms, cultural genocide or ethnocide, and the cultural destruction of peoples, have been held not to be recognized as part of federal common law.¹⁶⁰ However, since the law of nations is a body of law that continues to evolve, the law may be extended to accommodate these harms.

The Supreme Court gave further guidance on acknowledging new ATCA causes of actions on the basis of contemporary international law in *Sosa v. Alvarez-Machain*.¹⁶¹ The Court held that for tortious conduct that has not been recognized by existing case law as violations of international law to be regarded as acceptable causes of action under ATCA, they must be “accepted by the civilized world” and “defined with specificity.”¹⁶² In particular, the Court suggested that the level

¹⁵¹ See *Filartiga*, 630 F.2d at 888.

¹⁵² *Id.*

¹⁵³ *Id.* at 880.

¹⁵⁴ *Id.* at 878.

¹⁵⁵ *Tel-Oren*, 762 F.2d 774 at 781 (D.C. CIR. 1984) (emphasis added).

¹⁵⁶ *Forti v. Suarez-Mason*, 694 F. Supp. 709, 709 (N.D. Cal. 1988).

¹⁵⁷ *Id.* at 710.

¹⁵⁸ Marcks, *supra* note 161, at 303.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Sosa v. Alvarez-Machain*, 542 U.S. 692 (2004).

¹⁶² *Id.* at 725.

of acceptance and specificity should match the eighteenth century counterparts, including “offenses against ambassadors”, “violations of safe conduct” and “piracy”.¹⁶³ Applying this standard, the Court found that “arbitrary arrest” as an alleged principle of international law was not sufficiently “defined” or “accepted” to warrant admitting a new cause of action.¹⁶⁴ The Court endorsed the *Filartiga* approach to finding credible, authoritative sources of international law.¹⁶⁵

Therefore, while ATCA can under certain circumstances be invoked to address gross human rights violations, it seems at present unlikely that other harms such as environmental harm or discrimination would be recognized as actionable under ATCA. While this development virtually eliminates the availability of ATCA to address harms short of gross human rights violations in the near future, it could on the other hand reassure financial institutions that their exercise of due diligence to detect and address the risk of social or environmental harms caused by their borrowers would not create a risk of liability.

- ***Extraterritorial Concerns***

The applicability of ATCA to address human rights violations and the role of banks in contributing to such violations seems to be very restricted as a result of recent case law, especially in cases where a non-U.S. corporation is sued for a violation of human rights that occurred abroad.

In its controversial decision in *Kiobel v. Royal Dutch Petroleum Co.*, the Supreme Court adjudicated a case in which foreign individuals sued non-U.S. corporate defendants for human rights abuses, including unlawful executions, atrocities, and torture, that allegedly occurred outside the U.S. soil.¹⁶⁶ The Supreme Court relied on the “presumption against extraterritorial application,” a rule of statutory construction which holds that a statute is not applicable outside U.S. territory if it does not explicitly say so.¹⁶⁷ Although the Court referenced its own case law that the presumption is not meant for jurisdictional questions, the Court extended the rule to ATCA, invoking the concern that Article III judges should not interfere in the sphere of foreign relations.¹⁶⁸ The Court ultimately held that ATCA claims need to “touch and concern” the United States with “sufficient force” to rebut the presumption against extraterritorial application.¹⁶⁹

Human rights litigation under ATCA suffered another blow with the Supreme Court’s decision in *Jesner v. Arab Bank, PLC*.¹⁷⁰ In that case, foreign citizens sued a Jordanian bank with offices worldwide for supporting terrorist organizations by letting them maintain bank accounts.¹⁷¹ A five-member majority agreed that non-U.S. corporate defendants are not subject to ATCA liability, although the justices did not reach an agreement on the underlying rationale.¹⁷²

¹⁶³ *Id.* at 720.

¹⁶⁴ *Id.* at 734-38.

¹⁶⁵ *Id.* at 733-34.

¹⁶⁶ *Kiobel II*, 569 U.S. at 124.

¹⁶⁷ *Id.* at 116-17.

¹⁶⁸ *Id.* at 116.

¹⁶⁹ *Id.* at 124-25 (majority opinion).

¹⁷⁰ *Jesner v. Arab Bank, PLC*, 127 S. Cr. 1432.

¹⁷¹ *Id.* at 1394.

¹⁷² *Id.* at 1470.

c) *Summary of the Modern ATCA Analysis and Potential Lender Liability under ATCA*

In determining whether a private actor may be legally liable in a claim brought under ACTA for a human rights abuse, the threshold question is whether the alleged tort is a violation of the law of nations. If it is determined that the alleged tort constitutes a violation of international law, the question whether a bank which loaned money to the perpetrator of that tort may incur liability depends on its role in relation to the tortious conduct, including its knowledge of the borrower's misconduct, the nature of the service or goods which the bank provided to the borrower or state actor, and with what purpose the bank acted.

The mere fact that a bank conducts human rights due diligence prior to a loan transaction is unlikely to open it to the risk of liability under ATCA. The conduct of due diligence is likely at best to generate knowledge on the bank's part of potential human rights violations that could result from the target project. As discussed above, knowledge, without more, does not trigger liability. On the other hand, for banks which provide only monetary assistance to borrowers, liability will not arise due to the inherent 'neutrality' of money. In addition, the recent case law which significantly reduced the applicability of ACTA to foreign corporations is likely to further shield multilateral development banks from potential liability under the ATCA.

In view of the mens rea requirement, it seems unlikely that a court could find a lender liable for human rights abuses committed by a borrower under ATCA. While certain courts have articulated a lower 'knowledge' requirement for mens rea, which could perhaps be met through the exercise of due diligence, a development bank's provision of financing is very unlikely to satisfy the actus reus requirement for ATCA liability. This is because the courts have ruled that money is fungible, and the provision of money alone cannot be the direct means through which a human rights violation can occur. This conclusion supports the proposition that MDBs may carry out human rights due diligence without triggering lender liability under a statute such as ACTA.

United Kingdom and European Union

1. Introduction to the Legal System

The United Kingdom is made of up several legal systems corresponding to each of its constituent countries (England, Wales, Scotland and Northern Ireland). Parties may choose which system of private law will govern their affairs, but all entities in the United Kingdom are subject to the public law of the UK as a whole, including its administrative and criminal law, as defined by Parliament and by judicial decisions on the basis of *stare decisis* within the UK's common-law system. England and Wales have a combined court system, while Scotland and Northern Ireland have their own court systems. Since the 1990s, Scotland and Northern Ireland have had their own devolved parliaments with lawmaking authority limited to specific areas,¹⁷³ while Wales has had its own since 2007.¹⁷⁴ For the purposes of this memo, the focus is on UK-wide public law and on English

¹⁷³ See, e.g., Scotland Act, 1998, c. 46, sch. 8, <https://www.legislation.gov.uk/ukpga/1998/46/schedule/8>.

¹⁷⁴ Sarah Carter, *Researching Legal System of the United Kingdom*, GLOBALEX (Feb. 2020), https://www.nyulawglobal.org/globalex/United_Kingdom1.html.

private law, as the latter, rather than other UK systems of law, is most frequently applied to international commercial transactions.¹⁷⁵

The United Kingdom is currently in negotiations with the 27 remaining European Union states on a post-Brexit trade deal, which may lead to a closer or more distant degree of harmonization with future EU regulation (existing regulation having been incorporated into domestic law via the “Great Repeal Bill” of 2018).¹⁷⁶ That act of parliament did not incorporate tertiary documents (i.e., guidance issued by the European Supervisory Authorities), leaving UK regulators to issue future interpretations of EU primary and secondary law, which some have worried may result in financial and other regulatory divergence over time.¹⁷⁷ The UK has ‘retained’ much of the corpus of EU law as it applied in the UK in December 2020, and to this extent EU laws will continue to have effect even now that the UK is no longer a member state.

Several areas of UK law including public law (environmental, criminal and other regulatory statutes, as well as procedural rules) and private law (insolvency law and corporate governance, among others) affect the scope of potential lender liability.

2. General Sources of Lender Liability under United Kingdom Law

Lender liability is a relatively new concept in the United Kingdom, coming to prominence in the early 1990s.¹⁷⁸ Lender liability law in the United Kingdom appears to have been influenced by developments in the U.S. and Canada, with CERCLA (discussed above) being particularly significant.¹⁷⁹ (For a more in-depth discussion of CERCLA liability, see *Section II(A)(2)(a)* above.)

In the UK, for the most part, lenders must actually maintain control over the operations of a borrowing party in order for liability to arise. English case law on the issue of lender liability is most developed in the areas of corporate governance and environmental protection, which are discussed below.

a) The “Shadow Director” Test and Principal Control

To find a lending institution liable for harms caused by a project or company to which funding is provided, courts in the United Kingdom have required a showing that the lender exercises actual control over the principal’s actions, such that it can be considered a ‘shadow director’.¹⁸⁰ The

¹⁷⁵ See generally Gilles Cuniberti, *The International Market for Contracts: The Most Attractive Contract Laws*, 34 NW. J. INT’L L. & BUS. 455 (2014), <http://scholarlycommons.law.northwestern.edu/njilb/vol34/iss3/3>.

¹⁷⁶ European Union (Withdrawal) Act 2018, c. 16 (UK). See also *Explainers: EU Withdrawal Act 2018*, INSTITUTE FOR GOVERNMENT (Nov. 7, 2018), <https://www.instituteforgovernment.org.uk/explainers/eu-withdrawal-act>.

¹⁷⁷ Thomas Donegan, *Brexit: The Great Repeal Bill*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Aug. 13, 2017), <https://corpgov.law.harvard.edu/2017/08/13/brexit-the-great-repeal-bill/>.

¹⁷⁸ Al-Tawil, T.N. (2017), “Is a lender environmentally liable for the simple act of lending money?”, *International Journal of Law and Management*, Vol. 59 No. 3, pp. 348

¹⁷⁹ *Id.* at 342; Fordham, Michael, *Lender Liability: Could it Happen in the UK?*, RECIEL vol. 1 no. 4, at 429, available at <https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1467-9388.1992.tb00070.x>

¹⁸⁰ Marks, Jonathan H., *The Environmental Liability of Lenders in England: Is the Tide Coming in*, N.C. Journal of International Law and Commercial Regulation, vol. 27 no. 1, available at <https://scholarship.law.unc.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1690&context=ncilj>

notion of shadow directors first entered UK law with the Companies Act of 1985, four years before the Australian Corporations Act adopted an analogous definition of the term.¹⁸¹ There is no universal, authoritative test used to determine whether a borrowing entity (usually a company in distress) is acting under the command of a shadow director. Instead, courts in England have adopted a broad view in their judgments, “taking into account all the relevant factors” necessary to render judgment.¹⁸²

Under the shadow director principle, UK courts have found a lender principally liable for the actions of a borrower/beneficiary where the lender “lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself.”¹⁸³ A lender acting as a shadow director need not claim a formal role in the principal polluter’s governance structure.¹⁸⁴ This definition is in line with that found in Section 251(1) of the UK Companies Act of 2006, designating as a shadow director an institution under whose directions the principal actor is “accustomed to act.”¹⁸⁵

Providing expertise, resources or financial support to an organization or company does not establish the lender’s ‘shadow director’ status without proof of affirmative control over the project in general or, more specifically, over the events leading to the injury or harm in question.¹⁸⁶ In the *Hydrodan* case, the court created a four-prong test for determining whether a defendant corporation had been under the authority of a shadow director.¹⁸⁷ To establish that an entity acted as a shadow director, the court in *Hydrodan* looked to:

1. Who the apparent directors of the borrowing company are, and whether they have been appointed *de facto* or *de jure*;
2. Whether an entity or person not among the above defined directors has influenced the decisions, or decision-making process, undertaken by the principal;
3. Whether the apparent directors’ decisions have been swayed by the influence exerted;
4. Whether the directors were accustomed to accommodating outside influence from this particular source.¹⁸⁸ Notably, for the last prong, the court decided that only a “pattern of

¹⁸¹ Locke, Natania, *Shadow Directors: Lessons from Abroad*, *South African Mercantile Law Journal*, no. 14 (2002), at 420.

¹⁸² *Secretary of State for Trade and Industry v Tjolle & Ors* [1998] BCC 282

¹⁸³ *In Re Hydrocam (Corby) Ltd.*, [1994] 2 B.C.L.C. 180. Later cases, such as *Re Kaytech International plc* [1999] 2 BCLC 351, clarified that “lurking” does not necessarily imply illegal activity, defining persons and entities who direct the company’s legitimate business from a non-official position as shadow directors. Note that, as explained subsequently by *Sec. of State for Trade v. Deverell*, [2000] 2 W.L.R. 907, 920 (C.A.), a shadow director may not try to conceal their control over the client entity at all.

¹⁸⁴ *Sec. of State for Trade v. Deverell*, [2000] 2 W.L.R. 907, 920 (C.A.); *Re a Company ex p Copp*, [1989] B.C.L.C. 18.

¹⁸⁵ UK Companies Act of 2006, §251(1)

¹⁸⁶ *See Contaminated Land (Eng.) Regulations*, (2000) SI 2000/227, cited in Marks, *Environmental Liability*, at 11.

¹⁸⁷ *Re Hydrodan (Corby) Ltd.*, [1994] 2 BCLC 180

¹⁸⁸ *Id.*

behaviour” by the accommodating board will conclusively establish the shadow director’s influence.¹⁸⁹

Government guidance and decisions following *Hydrodan* looked to specify the threshold above which a person or entity may be considered a shadow director. The UK Department of the Environment, Transport and the Regions (“DETR”) adopted the position that a shadow director must have been “involved in some active operation, or series of operations” directly linked to the harm caused, adding that “[s]uch involvement may also take the form of a failure to act in certain circumstances.”¹⁹⁰ Although this rule is broad, it is not such as to not impose liability on advisors or third parties with mere knowledge of wrongdoing by deeming them to be shadow directors. In the government’s formulation, shadow directors must possess the knowledge of potential or actual harm and the effective power to prevent this injury.¹⁹¹ *Secretary of State for Trade and Industry v. Deverell* articulates a set of factors to distinguish between advice on the one hand, and instruction relayed to the directors by an outside source on the other.¹⁹² Relevant evidence may include a showing of how consistently the directors acted on a given advisor’s recommendations.¹⁹³

Recently, the Australian case *Buzzle Operations Pty Ltd. v. Apple Computer Australia Pty Ltd.*, (discussed in *Section II(D)(1)* below), has influenced the understanding of the shadow director principle in English courts.¹⁹⁴ In *In Re Paycheck*, the Supreme Court expressed dissatisfaction with the applicable legal framework.¹⁹⁵ The Supreme Court in that case departed from the factor-based analytical framework introduced in *Hydrodan*, and increased the level of attention paid to who exercises “real influence” over an entity.¹⁹⁶ However, courts in England have continued to rely on the *Hydrodan* factors, but informed by the limitations articulated in the Australian *Buzzle* case.¹⁹⁷ These limitations include requiring that the advice or instruction supplied to the directors by an outside entity must relate to “director matter,” and that the injury or harm caused and the activity of the company’s shadow director be connected by a plausible causal link.¹⁹⁸

Once the court finds that an entity has acted as a shadow director, it will impose the same standards of liability as for the actual defendant.¹⁹⁹ In the context of environmental protection, courts look

¹⁸⁹ *Id.*; Jamieson, Neil, Hughes, Kelly, *The Identification of Shadow Directors under English Law: What Guidance May Buzzle Provide?*, Butterworths J. International Banking and Financial Law, vol. 27 no. 6 (2012), 364, available at https://www.clydeco.com/clyde/media/fileslibrary/Publications/2012/JIBFL_27_06_13_Jamieson.pdf

¹⁹⁰ Marks, *Environmental Liability*, at 11.

¹⁹¹ DETR Circular, 9.14, Annex 2, cited in Marks, *Environmental Liability*, at 14, *see also* Shanks & McEwan Teesside Ltd. v. Env’t Agency, [1999] Q.B. 333, 342-45 (Q.B. Div’l Ct 1997).

¹⁹² *Secretary of State for Trade and Industry v Deverell* [2000] 2 BCLC 133

¹⁹³ *Id.*

¹⁹⁴ Jamieson, *Identification of Shadow Directors*, at 365.

¹⁹⁵ *Re Paycheck Services 3 Ltd* [2010] UKSC 51; UK Companies Act, §§ 250, 251.

¹⁹⁶ Jamieson, *Identification of Shadow Directors*, at 365; *Paycheck*, *supra*.

¹⁹⁷ *Id.*

¹⁹⁸ *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* [2010] NSWSC 233

¹⁹⁹ *See Re Tasbian* [1993] B.C.L.C. 297 (C.A.), *cited in* Marks, *Environmental Liability*, at 8; *Deverell*, *supra*.

for a direct causal link to the harm.²⁰⁰ Once this link has been established, the standard of strict liability is used.²⁰¹

b) Liability Through Ownership and Mortgages

A financial institution's ownership of property through a mortgage contract has been used by UK courts to establish liability for environmental harms caused by its tenants.²⁰² *Westminster City Council v. Haymarket Publishing* established the property owner's liability for harms caused on the property, so long as the property owner also had the right to manage the tenants.²⁰³

Liability may also be incurred if a mortgagor "caused or knowingly permitted" the polluting activity.²⁰⁴ Finally, if the otherwise liable tenant cannot be found, the Environmental Protection Act of 1990 directs courts to seek compensation from the owners of the tenant's leased property.²⁰⁵ In doing so, the 1990 act placed a burden to monitor the tenants' activities onto mortgagors as well as owners.

3. Lender liability for environmental and social harm

c) Environmental Liability: Statutory Basis and Limits

It has been suggested that the UK and the EU have a "strong-potential" lender environmental liability structure, in that they contemplate liability of a financial institution for environmental harm in several sets of circumstances.²⁰⁶ In practice, however, contractual mechanisms and business practices tend to insulate lenders from environmental liability.

EU Directive 2004/35/CE on environmental liability defines an operator as, "any natural or legal, private or public person who operates or controls the occupational activity or, where this is provided for in national legislation, to whom decisive economic power over the technical functioning of such an activity has been delegated, including the holder of a permit or authorization for such an activity or the person registering or notifying such an activity."²⁰⁷ While EU courts have provided little clarification on the definition of "operator," recent UK case law discussed below suggest possible theories of attribution that could result in lenders being held liable for environmental and social harms. When an enforcing authority pays remediation costs after a borrower fails to, lenders may find themselves indirectly liable in the form of a lower price at sale or indemnification of remediation costs by the buyer of the land, upon which those costs are assessed.²⁰⁸

²⁰⁰ See, e.g., UK Environmental protection Act, § 33

²⁰¹ *Alphacell v. Woodward*, [1972] 1 A.C. 824, 842 (H.L.).

²⁰² Jarvis, J. and Fordham, M. (1993), *Lender Liability Environmental Risk and Debt*, 1st ed., Cameron May, London, p. 2., cited in Al-Tawil, *supra*, at 359.

²⁰³ *Westminster City Council v. Haymarket Publishing* [1982] 1 W.L.R. 677; see also *Meigh v. Wickenden* [1942] 2KB 160.

²⁰⁴ United Kingdom Water Resources Act, § 85.

²⁰⁵ Hooley, Richard, *Lender Liability for Environmental Damage*, Cambridge Law Journal, no. 60 (2001), at 408.

²⁰⁶ UNEP, *Lenders and Investors Environmental Liability: How Much is too Much?* (Inquiry Working Paper No. 16/07, Apr. 2016), at 6.

²⁰⁷ Directive 2004/35/CE of the European Parliament and of the Council of Apr. 21, 2004 on environmental liability with regard to the prevention and remedying of environmental damage, 2004 O.J. (L 143), art. 2(6).

²⁰⁸ EPA 1990, §§ 78N, 78P; *Westminster City Council v Haymarket* [1981] 2 All ER 555; *Banking and finance and environmental issues—overview*, Lexis PSL,

The EU Directive is also significant for enshrining the polluter-pays principle in EU law. Nevertheless, this principle is usually enforced by the imposition of administrative duties on public authorities rather than through civil suits.²⁰⁹ The directive provides for strict liability or fault-based liability, depending on whether the activity in question is listed in Annex III.²¹⁰ Similarly, the UK's Environment Agency ("EA") generally prefers ex-ante regulation to using enforcement powers, holding those for significant damage or repeated conduct.²¹¹ This means that there is little role for private litigation in environmental enforcement.

Much of the discussion of lender liability for environmental harms in the UK has focused on the potential for direct liability under UK environmental law, and particularly under the contaminated land regime in Part IIA of the Environmental Protection Act 1990.²¹² Accordingly, banks have created lending structures to reduce these risks, making other forms of environmental risk more significant, such as reputational harm or secondary financial risks e.g. to borrower cash-flow or the depreciation of assets securing mortgages.²¹³

Addressing direct liability first, "operators" can be found liable under the Environmental Protection Act 1990, Environment Act 1995 – Contaminated Land, Water Resources Act 1991 or, common-law nuisance, when they became involved in the management of the pollution, enforced security or now own the contaminated land.²¹⁴ Ordinarily, lenders are not exposed under these frameworks to pollution-related liability; as it is only when a lender takes possession or takes a more active role in management that it is considered a "cause", a "knowing permitter" or an "owner/occupier".²¹⁵ Typically, lenders contract to control for these risks when they are aware of them at the time of drafting. However, when a contamination problem arises during the term of a loan, those three roles become relevant. "Causing" pollution typically requires active control, with the paradigmatic example (even if rare) being a shadow director of the project, since the exercise of certain contractual rights may lead to control. (See *Section II(B)(2)* for a greater discussion on "shadow director" status.)

https://www.lexisnexis.com/uk/lexispsl/environment/document/393763/55KB-D851-F18C-10D9-00000-00/Banking_and_finance_and_environmental_issues_overview (last accessed Oct. 1, 2020, 4:31pm).

²⁰⁹ European Parliament Policy Department for Citizens' Rights and Constitutional Affairs Directorate-General for Internal Policies, *Environmental Liability of Companies* (May 2020),

[https://www.europarl.europa.eu/RegData/etudes/STUD/2020/651698/IPOL_STU\(2020\)651698_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2020/651698/IPOL_STU(2020)651698_EN.pdf).

²¹⁰ *Id.* at 14.

²¹¹ Vanessa Havard-Williams, Sarah Barnard and Ben Shanks-St John, Linklaters LLP, *Environmental liability in the United Kingdom*, Lexology (Nov. 15, 2018), <https://www.lexology.com/library/detail.aspx?g=813aa5cc-40de-4674-b04c-c50bee46ae09>.

²¹² Lloyd A. Brown, *Land pollution, environmental risks and bank lending: An empirical analysis*, 17 E.L.R. 4 (2015).

²¹³ *Id.*

²¹⁴ Vanessa Havard-Williams, Sarah Barnard and Ben Shanks-St John, Linklaters LLP, *Environmental liability in the United Kingdom*, Lexology (Nov. 15, 2018), <https://www.lexology.com/library/detail.aspx?g=813aa5cc-40de-4674-b04c-c50bee46ae09>; UNEP, *Lenders and Investors Environmental Liability: How Much is too Much?* (Inquiry Working Paper No. 16/07, Apr. 2016), at 10.

²¹⁵ Nicholas Rock & Siobhan Hates, *Brownfield land in the UK: lenders' liability*, REED SMITH (Apr. 30, 2014), <https://www.reedsmith.com/en/perspectives/2014/04/brownfield-land-in-the-uk-lenders-liability>.

“Knowingly permitting” pollution is a broader category, resting on a lender knowing of, and having had a reasonable opportunity to address such risks. Liability here rests on the degree of control, and not on the mere fact of a lender being a mortgagee. Finally, if a lender takes possession of contaminated land, thereby becoming an “owner/occupier”, this may raise the prospect of liability if the borrower is forced to liquidate or cannot meet the costs of cleanup.²¹⁶

In the UK, the permit-holder who undertakes the act is primarily liable, and the risk is usually allocated in the relevant contracts.²¹⁷ Permit-holder liability cannot be incurred when activity is authorized by a permit unless third parties challenge its terms or the permit is violated.²¹⁸ Such third-party challenges are frequent²¹⁹ but present a high threshold for success.²²⁰

Permit violations could give rise to liability if a lender takes over operational control from the borrower/permit-holders. However, the UK’s liability regime for limited liability companies creates a risk of under-deterrence because §178 of UK Insolvency Act 1986 allows a liquidator, with court permission, to disclaim onerous property without carving out waste licenses, such that insolvent companies and their lenders can escape liability for harms related to the licenses.²²¹ Court decisions have limited the ability to include environmental liabilities as liquidation costs, with legislative inaction leaving gaps in the environmental liability regime as a result.²²²

Under EU law the legal standard applied to operators – which can include lenders in the situations described above - depends on the activity in question.²²³ Outside of certain activities to which strict

²¹⁶ *Id.*

²¹⁷ Vanessa Havard-Williams, Sarah Barnard and Ben Shanks-St John, Linklaters LLP, *Environmental liability in the United Kingdom*, Lexology (Nov. 15, 2018), <https://www.lexology.com/library/detail.aspx?g=813aa5cc-40de-4674-b04c-c50bee46ae09>.

²¹⁸ Vanessa Havard-Williams, Sarah Barnard and Ben Shanks-St John, Linklaters LLP, *Environmental liability in the United Kingdom*, Lexology (Nov. 15, 2018), <https://www.lexology.com/library/detail.aspx?g=813aa5cc-40de-4674-b04c-c50bee46ae09>.

²¹⁹ Michael Coxall & Elizabeth Hardacre (Clifford Chance LLP), *Environmental law and practice in the UK (England and Wales): overview*, THOMAS REUTERS PRACTICAL LAW (Jul. 1, 2020), [https://uk.practicallaw.thomsonreuters.com/6-503-1654?__lrTS=20200404135123044&transitionType=Default&contextData=\(sc.Default\)&firstPage=true#co_anchor_a309232](https://uk.practicallaw.thomsonreuters.com/6-503-1654?__lrTS=20200404135123044&transitionType=Default&contextData=(sc.Default)&firstPage=true#co_anchor_a309232)

²²⁰ See e.g. *Baci Bedfordshire Ltd, R (on the application of) v The Environment Agency & Anor* [2019] EWCA Civ 1962; *Court of Appeal rejects challenge to environmental permit for waste incineration plant over error in supporting information*, PUBLICLAW TODAY (Dec. 3, 2019), <https://www.publiclawtoday.co.uk/planning/401-planning-news/42089-court-of-appeal-rejects-challenge-to-environmental-permit-for-waste-incineration-plant-over-error-in-supporting-information>.

²²¹ Irene Lynch Fannon, *Managing Waste: the gap between EU Directives and corporate law in Member States – a mess of case law needing a clean-up*, 6 *Env. Liability* 203 (2016).

²²² Studies have found that 5% of costs in the EU are borne by public funds due to polluters being non-extant, unidentifiable or insolvent : Tim Friehe and Eric Langlais, *Prevention and cleanup of dynamic harm under environmental liability*, 83 *J.ENV.ECON.&MGMT.*107 (2017).

²²³ Environmental damage, once shown, gives rise to strict liability under EU law when the activity is one of those included in Annex III, including those involving dangerous substances or a broad range of waste management activities as defined by other EU law Directive 2004/35/CE, Annex III.

liability applies, i.e., in most situations in which a lender might be found liable, a negligence or other fault standard is applied.²²⁴

UK law limits strict liability to operators engaging in dangerous activities as defined by the Environmental Protection Act 1990,²²⁵ historic contaminated land under Circular 2/2006, Part 2A of the Environmental Protection Act 1990,²²⁶ and, most importantly, to any operator “causing” a discharge activity, distinguished from “knowingly permit[ing]” one under the frameworks above, under the Water Resources Act 1991. Otherwise, a negligence standard applies.²²⁷ While corporations can be held criminally liable under UK law, the requirement of proving not just the act prohibited by the offence (*actus reus*), as under the strict-liability statutes above, but also and that the company’s board, managing director or other superior officers had the required intent when committing such act (*mens rea*) sets a high bar.²²⁸

d) *Novel Common-Law Theories under which Liability might be imposed on Corporations or Lenders*

For the reasons described above, statutory liability for environmental harms is largely circumscribed in the UK, including as governed by relevant EU law. Historically, liability for social harms, which is regulated primarily by common law rather than by the kind of statutory and regulatory framework governing in the environmental domain, has been similarly limited.

Recent developments in UK case law, however, could point to a potentially new basis for liability resting on duties owed to third parties by corporate parents, deriving from their expertise and the existence of group-wide environmental and social compliance policies that create a basis for finding that the imposition of a duty of care is reasonable.²²⁹ ***While these cases have thus far been limited to the subsidiary-parent relationship, the question is whether a similar approach might possibly be applied to lenders, opening them up to certain tortious claims from which they have historically been insulated.***

(1) *Traditional, Control-Based Approach to the Duty of Care for Corporations*

As a general matter, the common-law framework for ascribing liability to corporate parents for the harm caused to a third party by a subsidiary depends on the degree of control exercised by

²²⁴ Directive 2004/35/CE, art. 3(1)(b). *Questions and Answers Environmental Liability Directive*, EUROPEAN COMMISSION, MEMO/07/157 (Apr. 27, 2007), https://ec.europa.eu/commission/presscorner/detail/en/MEMO_07_157/.

²²⁵ UNEP, *Lenders and Investors Environmental Liability: How Much is too Much?* (Inquiry Working Paper No. 16/07, Apr. 2016), at 10.

²²⁶ Mahfud Mahfud, *An Overview of Strict Liability Offences and Civil Penalties in the UK’s Environmental Law*, 9 *Jurnal Hukum dan Peradilan* 154, 158 (2020), https://www.researchgate.net/publication/341716805_AN_OVERVIEW_OF_STRICT_LIABILITY_OFFENCES_AND_CIVIL_PENALTIES_IN_THE_UK’S_ENVIRONMENTAL_LAW.

²²⁷ Nicholas Rock & Siobhan Hates, *Brownfield land in the UK: lenders’ liability*, REED SMITH (Apr. 30, 2014), <https://www.reedsmith.com/en/perspectives/2014/04/brownfield-land-in-the-uk-lenders-liability>.

²²⁸ ALEX MARX ET AL., *ACCESS TO LEGAL REMEDIES FOR VICTIMS OF CORPORATE HUMAN RIGHTS ABUSES IN THIRD COUNTRIES* 40 (Feb. 1, 2019), [https://www.europarl.europa.eu/thinktank/en/document.html?reference=EXPO_STU\(2019\)603475](https://www.europarl.europa.eu/thinktank/en/document.html?reference=EXPO_STU(2019)603475).

²²⁹ See in particular *Lungowe v Vedanta Resources plc* [2019] UKSC 20 and *Okpabi and others v Royal Dutch Shell Plc and another* [2021] UKSC 3

the parent company over the decisions of the subsidiary.²³⁰ This evidently presents significant obstacles to holding lenders, who typically do not exercise operational control, to account for harm flowing from their investments.

The leading cases address corporate harms by multinational resource extraction companies rather than lenders. *Caparo Industries plc v Dickman*, in which a corporate acquirer sued its auditor after finding undisclosed losses at the target company, set out the archetypal three-part test for establishing the requisite duty of care for negligence claims: foreseeability, proximity and whether such a duty was fair, just and reasonable.²³¹ The decision was viewed as making it significantly more difficult for corporations to bring claims against auditors, but it also produced a line of duty-of-care limitations on findings of negligence based on the third prong of the test.

An example of such limitation of liability in the social harm context is *Kadie Kalma. v African Minerals Ltd*, in which the UK company African Minerals was held not to owe a duty of care to local communities in relation to harms that had been suffered at the hands of the Sierra Leonean police during two incidents of unrest connected to the iron ore mine owned and operated by the respondents.²³² The claimants alleged that African Minerals Ltd (“AML”) created an exception to the general rule of ‘no duty of care’ when it created a danger by funding and supplying the police or, in the alternative, that a duty could be established under the *Caparo* test. However, the court found that none of the three prongs of the test was met, meaning that AML was not under any obligation to refrain from using state security services.²³³

(2) New, “Special Relationship” Approach and a Potential Duty of Care on Lenders

In contrast to the traditional control-based approach to the establishment of a duty of care giving rise to tort liability, a more recent line of cases indicates that where a “special relationship” exists between a parent company and its subsidiary, an expectation arises that control should be exercised by the former over the activities of the latter.²³⁴ This presumption of control was established in *Chandler v. Cape* (2012), where liability for asbestos-related harm was imposed on the parent

²³⁰ Nicolas Bueno and Claire Bright, *Implementing Human Rights Due Diligence Through Corporate Civil Liability*, 69(4) INT’L & COMP. L.Q. 17 (2020), doi: <http://dx.doi.org/10.1017/S0020589320000305>.

²³¹ *Caparo Industries plc v Dickman* [1990] UKHL 2.

²³² *Kadie Kalma v African Minerals Ltd* [2020] EWCA Civ 144; Nicolas Bueno and Claire Bright, *Implementing Human Rights Due Diligence Through Corporate Civil Liability*, 69(4) INT’L & COMP. L.Q. 22 (2020), doi: <http://dx.doi.org/10.1017/S0020589320000305>.

²³³ Julianne Hughes Jennett & Peter Hood, *Kalma v African Minerals: English Court of Appeal Judgment Cuts Against the Grain of Common Law Cases on the Responsibility of Businesses for Overseas Human Rights Impacts*, EJIL:Talk! (Mar. 24, 2020), <https://www.ejiltalk.org/kalma-v-african-minerals-court-of-appeal-judgment-cuts-against-the-grain-of-common-law-cases-on-the-responsibility-of-businesses-for-overseas-human-rights-impacts/#:~:text=Last%20week%2C%20the%20English%20Court,protection%20from%20state%20security%20for ces.>

²³⁴ Nicolas Bueno and Claire Bright, *Implementing Human Rights Due Diligence Through Corporate Civil Liability*, 69(4) INT’L & COMP. L.Q. 17 (2020), doi: <http://dx.doi.org/10.1017/S0020589320000305>.

company of a tortfeasor which no longer existed.²³⁵ The court mentioned several factors as the basis for its finding of a special relationship.²³⁶

In *Chandler*, a duty of care was based on the commonality of directors of the two companies, the existence of a group policy on health and safety, and parent responsibility over the subsidiary.²³⁷ Commentators arguing for a strict-liability framework for corporate wrongs have viewed the decision as hinting at a potential basis for holding parent companies liable based on the growing trend towards incorporation of subsidiary financial and environmental and social risk information in parent reporting.²³⁸

The UK Supreme Court in 2019 allowed a claim of negligence and breach of statutory duty against Vedanta Resource PLC (“*Vedanta*”) to proceed in connection with the pollution of drinking water in Zambia by Vedanta’s local subsidiary mining company.²³⁹ This case may have opened the door to claims in the UK against British parent companies which hold themselves out as taking active steps to supervise and control their subsidiaries’ compliance practices.²⁴⁰ The court in *Vedanta* presented the criteria outlined in the earlier *Chandler* case as being merely illustrative rather than necessary conditions.²⁴¹ It held out three possibilities for group-wide policies giving rise to parent company duty of care: (i) devising defective or ineffective group-wide policies; (ii) taking active steps, by training, supervision and enforcement, to see that they are implemented by relevant subsidiaries and (iii) holding itself out as exercising a certain degree of supervision and control of its subsidiaries, even if it does not in fact do so. The *Vedanta* case was followed in February 2021 by a similar ruling in *Okpabi*, in which the Supreme Court held that the lower court had been wrong to dismiss a case against a parent company (Royal Dutch Shell, which maintained group-wide environmental and other policies) brought by plaintiffs who had been injured by the environmentally damaging activities of a subsidiary company in Nigeria; that ‘control’ was not the only or main criterion for the imposition on a parent company of a duty of care in negligence, and that an important issue in the case was the vertical organizational structure of the company

²³⁵ *Chandler v Cape* [2012] EWCA Civ 525, para. 80.

²³⁶ These factors included: (i) the businesses of parent and subsidiary were in relevant respects the same (ii) The parent has or ought to have superior knowledge on some relevant aspect of health and safety in the particular industry (iii) The subsidiary’s system of work is unsafe as the parent company knew, or ought to have known of this (iv) The Parent company knew or ought to have foreseen that the subsidiary or its employees would rely on its using that superior knowledge for the employees’ protection

²³⁷ ALEX MARX ET AL., ACCESS TO LEGAL REMEDIES FOR VICTIMS OF CORPORATE HUMAN RIGHTS ABUSES IN THIRD COUNTRIES 78-83 (Feb. 1, 2019),

[https://www.europarl.europa.eu/thinktank/en/document.html?reference=EXPO_STU\(2019\)603475](https://www.europarl.europa.eu/thinktank/en/document.html?reference=EXPO_STU(2019)603475); Cees van Dam, *Tort Law and Human Rights: Brothers in Arms on the Role of Tort Law in the Area of Business and Human Rights*, 2 J. Eur. Tort L. 221 (2011).

²³⁸ Cees van Dam, *Tort Law and Human Rights: Brothers in Arms on the Role of Tort Law in the Area of Business and Human Rights*, 2 J. Eur. Tort L. 221 (2011).

²³⁹ *Vedanta Resource PLC and another v Lungowe and others*, [2019] UKSC 20.

²⁴⁰ See also Anita Lloyd, *UK Supreme Court Considering Parent Company Liability for Environmental Harm Caused by Overseas Subsidiaries*, FRESH LAW BLOG (May 1, 2019), <https://www.freshlawblog.com/2019/05/01/uk-supreme-court-considering-parent-company-liability-for-environmental-harm-caused-by-overseas-subsidiaries/>.

²⁴¹ *Lungowe v Vedanta Resources plc* [2019] UKSC 20, para. 56.

and the extent to which delegation of authority in relation to operational safety and environmental responsibility was allowed.²⁴²

While the argument has been made that a framework which exposes corporations with more comprehensive policies to more extensive liability could discourage voluntary human rights due diligence, others have argued all the more strongly for a comprehensive regime which sets out clearly the relationship between human rights due diligence and liability, and relevance of the parent-subsidiary relationship to it.²⁴³

The combination of these recent developments in the common law, eroding the shield historically afforded to corporations by focusing on compliance practices, and the broader trend towards non-financial reporting and due diligence, raise the question whether there could be an extension of these developments to the situation of lenders. In other words, do they suggest any similar prospect of lender liability for social harms? ***One possible argument is that while lenders do not satisfy many of the Chandler criteria, particularly those that focus on industry knowledge or closely related business lines, the factors outlined in Vendanta and Okpabi might be more readily applicable to financial institutions, which typically have group-wide environmental and social risk management policies.***²⁴⁴ ***Nevertheless, the absence of an integrated vertical structure, or of a close organizational relationship between a development bank and a borrower makes this seem less likely.***

4. Relevance of Human Rights Due Diligence to Lender Liability

Human rights due diligence is not expressly addressed in the few statutes and cases that impose environmental or social liability on lenders. And similarly, environmental and social reporting and due diligence requirements are generally set out without a clear statement as to how they may be relevant to the possibility of liability for violations in those areas.²⁴⁵ Mandatory reporting rules are generally silent on the question of liability and often lack extensive due diligence requirements. In those cases where substantive due diligence requirements are set out, they tend to be very limited in scope, for example being limited to specific issue areas or forms of harm.

The domestic law of some EU member states offer a few examples of human rights due diligence requirements which are connected to the question of liability. However, the current draft for a future EU Directive on human rights due diligence, while it specifies penalties for breach of reporting requirements, does not impose any liability to third parties and leaves the issue of liability to national laws to decide.²⁴⁶ The draft Directive – which seems likely to apply to companies

²⁴² *Okpabi and others v Royal Dutch Shell Plc and another* [2021] UKSC 3

²⁴³ Nicolas Bueno and Claire Bright, *Implementing Human Rights Due Diligence Through Corporate Civil Liability*, 69(4) INT'L & COMP. L.Q. 17 (2020), doi: <http://dx.doi.org/10.1017/S0020589320000305>.

²⁴⁴ Iris H-Y Chiu, *Unpacking the Reforms in Europe and UK Relating to Mandatory Disclosure in Corporate Social Responsibility: Instituting a Hybrid Governance Model to Change Corporate Behaviour?*, 14 Eur. Co. L. 5, 16 (2017), <https://discovery.ucl.ac.uk/id/eprint/1566612/1/Corporate%20Social%20Responsibility%20ECL%20v4.pdf>.

²⁴⁵ Nicolas Bueno and Claire Bright, *Implementing Human Rights Due Diligence Through Corporate Civil Liability*, 69(4) INT'L & COMP. L.Q. (2020), doi: <http://dx.doi.org/10.1017/S0020589320000305>.

²⁴⁶ https://www.europarl.europa.eu/doceo/document/JURI-PR-657191_EN.pdf

providing financial services and to public and private companies alike²⁴⁷ - specifies that the fact that a company has carried out its due diligence obligations does not exempt it from civil liability under other existing laws,²⁴⁸ but suggests that having a robust due diligence process in place should help companies to avoid causing harm in the first place. The Directive would require member states to introduce laws imposing liability on companies for environmental and human rights harm caused by entities under their control, but also clarify that companies should not be held liable if they can prove that they took all due care to avoid the loss or damage that occurred.²⁴⁹ However, it is unclear whether the UK would follow the EU's mandatory due diligence law once adopted, now that it is no longer an EU member state.

a) *Mandatory Reporting without Liability*

Reporting of social and environmental risks is often made mandatory without any explicit due diligence requirements or indicating any relationship to liability. In the UK, Corporate Environmental and Social Disclosures ("CESD") have been mandatory to some degree since 1968, with increasing external pressure on firms from the 1970s to 1990s.²⁵⁰ However, while reporting may be mandatory, the shape that due diligence takes is left for the most part to corporations themselves, who in turn tend to look to standards like ISO14001 for environmental management.²⁵¹

One example is §54 of the UK Modern Slavery Act of 2015 ("MSA"),²⁵² which requires corporations with a certain annual threshold turnover to detail any steps taken to ensure slavery and human trafficking are not present in their supply chain or business, or the lack thereof.²⁵³ However, this statement is not required to be accompanied by any mandated due diligence, nor is there any financial penalty for non-compliance, although the Home Secretary can seek a court injunction if a company fails to issue a statement.²⁵⁴ Moreover, investments are typically not considered part of an investment fund manager's own businesses or supply chain for the purposes of the MSA, even if including information on human rights risk assessment in their investment strategies is recommended by practitioners.²⁵⁵

²⁴⁷ <https://www.allenoverly.com/en-gb/global/news-and-insights/publications/a-first-step-towards-eu-wide-legislation-on-mandatory-human-rights-due-diligence>

²⁴⁸ Ibid, draft Directive Article 20.

²⁴⁹ Ibid, recital 39 to the draft Directive.

²⁵⁰ Jason Zezheng Xiao, Simon S.Gao, Saeed Heravi & Yuk C.Q.Cheung, *The Impact of Social and Economic Development on Corporate Social and Environmental Disclosure in Hong Kong and the U.K.*, 18 ADVANCES IN INT'L ACCOUNTING 219, 222 (2005), <https://www.sciencedirect.com/science/article/pii/S0897366005180118>.

²⁵¹ Iris H-Y Chiu, Unpacking the Reforms in Europe and UK Relating to Mandatory Disclosure in Corporate Social Responsibility: Instituting a Hybrid Governance Model to Change Corporate Behaviour?, 14 Eur. Co. L. 5, 16 (2017), <https://discovery.ucl.ac.uk/id/eprint/1566612/1/Corporate%20Social%20Responsibility%20ECL%20v4.pdf>.

²⁵² Nicolas Bueno and Claire Bright, *Implementing Human Rights Due Diligence Through Corporate Civil Liability*, 69(4) INT'L & COMP. L.Q. (2020), doi: <http://dx.doi.org/10.1017/S0020589320000305>.

²⁵³ U.N. OHCHR, *Consultation: The Relevance of Human Rights Due Diligence to Determinations of Corporate Liability* (Oct. 5-6, 2017), at 5.

²⁵⁴ Sharon Benning-Price, *A Guide to the Modern Slavery Act for Your Business*, CONTRACT STORE (Jul. 31, 2015), <https://www.contractstore.com/blog/uk-law/a-guide-to-the-modern-slavery-act-your-business-could-be-affected/>.

²⁵⁵ Michael R. Littenberg et al., *The UK Modern Slavery Act – A Compliance Primer for Fund Managers*, ROPES & GRAY (Feb. 15, 2017), <https://www.ropesgray.com/en/newsroom/alerts/2017/02/The-UK-Modern-Slavery-Act-A-Compliance-Primer-for-Fund-Managers>.

Similarly, the EU's Non-Financial Reporting Directive 2014/95 imposes mandatory reporting duties on listed companies, banks, insurers and other nationally designated public-interest entities to disclose their policies on environmental protection, social responsibility, labor, human rights, anticorruption and diversity.²⁵⁶ However, the form of these reports is left open, which allows reporting companies to choose whether to follow international, national or European guidelines.

As indicated in the previous section, further EU initiatives are currently underway to mandate more comprehensive reporting by EU companies. In addition to the Draft Directive on due diligence, the European Parliament's recent briefing paper on potential EU-wide regulation on business and human rights due diligence surveyed current laws, including the UK's MSA discussed above.²⁵⁷ While the paper made no specific mention of lenders, it made clear that any future EU regulation would be broad in scope, covering all business activity and human rights risks, and consider risks throughout their entire supply chain.²⁵⁸

b) Comprehensive human rights due diligence without Clear Liability

Some legislative measures provide more specificity as to the form that due diligence should take but rely on public authorities for monitoring and enforcement rather than creating a civil liability mechanism.²⁵⁹ EU legislation has often taken this form, including Regulation (EU) No 995/2010 of the European Parliament and of the Council of 20 October 2010 laying down the obligations of operators who place timber and timber products on the market²⁶⁰ and Regulation (EU) 2017/821 of the European Parliament and of the Council of 17 May 2017 laying down supply chain due diligence obligations for Union importers of tin, tantalum and tungsten, their ores, and gold originating from conflict-affected and high-risk areas.²⁶¹ These due diligence requirements likely do not affect financial institutions as they would not be classified as ore importers or timber sellers.

c) Explicitly Associated HRDD and Liability

As the European Parliament's survey of member state law shows, there are very few laws which explicitly stipulate the relationship between human rights due diligence and liability on the part of corporations or lenders.²⁶² The only example in the UK is the Bribery Act 2010, which includes a

²⁵⁶ EU Directive 2014/95 of 22 October 2014 on disclosure of non-financial and diversity information by certain large undertakings [2014] OJ 2014 L 330/1; *Non-financial reporting*, EUROPEAN COMMISSION, https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en (last accessed Oct. 2, 2020, 5:53pm).

²⁵⁷ Pol. Dept., EU Directorate-General for External Policies, *Briefing No. 1: Substantive Elements of Potential Legislation on Human Rights Due Diligence* (Jun. 2020), [https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/603495/EXPO_BRI\(2020\)603495_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/603495/EXPO_BRI(2020)603495_EN.pdf).

²⁵⁸ *Id.*, at 14.

²⁵⁹ Nicolas Bueno and Claire Bright, *Implementing Human Rights Due Diligence Through Corporate Civil Liability*, 69(4) INT'L & COMP. L.Q. 11 (2020), doi: <http://dx.doi.org/10.1017/S0020589320000305>.

²⁶⁰ EU Regulation 995/2010 of 20 October 2010 laying down the obligations of operators who place timber and timber products on the market [2010] OJ L295/23.

²⁶¹ EU Regulation 2017/821 of 17 May 2017 on supply chain due diligence obligations for Union importers of tin, tantalum and tungsten, their ores, and gold originating from conflict-affected and high-risk areas [2017] OJ L130/1.

²⁶² Pol. Dept., EU Directorate-General for External Policies, *Briefing No. 1: Substantive Elements of Potential Legislation on Human Rights Due Diligence* (Jun. 2020), [https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/603495/EXPO_BRI\(2020\)603495_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/603495/EXPO_BRI(2020)603495_EN.pdf).

defense to liability where a corporation can show that it had adequate procedures in place.²⁶³ Such procedures, could, for example, be that human rights due diligence had been conducted. The term “adequate” is left undefined in the Act but guidance from the Ministry of Justice in 2011 and the Serious Fraud Office’s Operational Handbook hint at the relevant criteria.²⁶⁴ The key consideration is the state of the compliance program at the time of offending, although subsequent efforts can influence the decision of public authorities to prosecute or the sentencing or terms of a deferred prosecution agreement.²⁶⁵ The six broad, guiding principles are: proportionate procedures, top level commitment, risk assessment, due diligence, communication and monitoring and review.

Elsewhere in Europe, the 2017 French Duty of Vigilance Law imposes a duty of care on corporations, which is enforceable by injunction or by civil suit under a fault liability regime.²⁶⁶ The law imposes a duty on corporations to devise, disclose and implement a vigilance plan to monitor human rights and environmental harms in their operations, those of companies under their control or subcontractors or suppliers with whom they have an established relationship. This French law creates a duty of care for corporations which is similar in ways to that imposed in the *Vedanta* case, creating a link between civil liability and human rights due diligence.

²⁶³ UK Bribery Act 2010 §7. See G LeBaron and A Rühmkorf, *Steering CSR Through Home Art Regulation: A Comparison of the Impact of the UK Bribery Act and Modern Slavery Act on Global Supply Chain Governance*, 8 GLOBAL POLICY 15 (2017); I Pietropaoli et al., *A UK Failure to Prevent Mechanism for Corporate Human Rights Harms* 2019 BIICL 48-55.

²⁶⁴ Peter Ibrahim & Zoe Osborne, *The UK Bribery Act: Adequate Procedures but Inadequate Guidance?*, STEPTOE: INTERNATIONAL COMPLIANCE BLOG (Jan. 27, 2020), <https://www.steptoointernationalcomplianceblog.com/2020/01/the-uk-bribery-act-adequate-procedures-but-inadequate-guidance/>.

²⁶⁵ *Ibid.*

²⁶⁶ CODE DE COMMERCE [C. COM.] [COMMERCIAL CODE] art. L.225-102-4(I) (Fr.); Nicolas Bueno and Claire Bright, *Implementing Human Rights Due Diligence Through Corporate Civil Liability*, 69(4) INT’L & COMP. L.Q. 11 (2020), doi: <http://dx.doi.org/10.1017/S0020589320000305>.

B. Hong Kong Special Administrative Region (P.R. China)

1. Introduction to Hong Kong's Legal System and Political Structure

a) The Legal System in Hong Kong

As one of the most important international financial centers, the Hong Kong Special Administrative Region of China (“Hong Kong”) is one of the most popular jurisdictions in international commercial transactions. Its judiciary had a long-standing reputation for fairness and was rated as one of the best judicial systems in the Asia Pacific Region.²⁶⁷ Hong Kong law has thus been broadly accepted as a choice for the law to govern cross-border agreements.²⁶⁸

Hong Kong, while constitutionally integrated into China, retains the common law system of governance used during its 150 years under the jurisdiction of the United Kingdom.²⁶⁹ On July 1, 1997, the sovereignty of Hong Kong was restored to China through an agreement known as the Joint Declaration of the United Kingdom and China on the Question of Hong Kong (the “Joint Declaration”) promulgated in 1984.²⁷⁰ It sets out the basic policies of China towards Hong Kong.²⁷¹ The Joint Declaration stipulates that Hong Kong will enjoy a high degree of autonomy, except for foreign and defense affairs. In contrast, Mainland China maintains a socialist system with a civil law system.

The official sources of law in Hong Kong include: 1) Basic Law, 2) common law and rules of equity, 3) statutory law, 4) Chinese customary law, and 5) international law.²⁷²

(1) Basic Law

The constitutional framework for Hong Kong’s legal system is provided by the Basic Law, which is enacted by the National People’s Congress of the People’s Republic of China in accordance with Article 31 of the Constitution of China. The Basic Law takes precedence over all laws enacted in Hong Kong, and all public policies and practices must be based upon the Basic Law. In addition to setting out the status of Hong Kong as a Special Administrative Region of China, “one country, two systems” principles for the social and economic systems, the system to protect individual rights and freedoms as well as the political structure, it affirms that the capitalist system shall

²⁶⁷ Philip R Wood, *Ten Points for Choosing the Governing Law of an International Business Contract*, INT’L BAR ASS’N (Jan. 2020), <https://www.ibanet.org/Article/NewDetail.aspx?ArticleUid=1a3ef62c-4d40-4b25-8002-00e6b9e8224c>.

²⁶⁸ According to a 2019 study by Ipsos and the Singapore Academy of Law, the most preferred choice of governing law in cross-border transactions was English law at 48%. Singapore law was second at 25%, with New York at 7% and Hong Kong at 3%. See 2019 Study on Governing Law & Jurisdictional Choices in Cross-border Transactions at 4 (2019), https://www.sal.org.sg/sites/default/files/PDF%20Files/Newsroom/News_Release_PSL%20Survey_2019_Appendix_A.pdf.

²⁶⁹ See Hong Kong: The Facts, Legal System, GovHK, https://www.gov.hk/en/about/abouthk/factsheets/docs/legal_system.pdf.

²⁷⁰ Joint Declaration on the question of Hong Kong (Dec. 19, 1984), <https://treaties.un.org/doc/Publication/UNTS/Volume%201399/v1399.pdf>.

²⁷¹ *Id.*

²⁷² See Legal System in Hong Kong, Dep’t of Justice, The Government of the Hong Kong Special Administrative Region (last updated Feb. 8, 2018), <https://www.doj.gov.hk/eng/legal/index.html>.

remain in force for 50 years from the inception of the Special Administrative Region.²⁷³ However, the newly enacted Hong Kong national security law²⁷⁴ will undoubtedly shape the future of Hong Kong, and it raises major questions about the autonomy of the city and its legal system.²⁷⁵

(2) Common Law and Rules of Equity

Hong Kong's common law system utilizes judicial precedent to interpret and enforce the law. According to Article 84 of the Basic Law, Hong Kong judges may refer to judicial decisions, as precedents, from any common law jurisdiction.²⁷⁶ Additionally, the Court of Final Appeal as well as the judiciary generally are permitted to invite judges from other common law jurisdictions to serve in Hong Kong.²⁷⁷

(3) Statutory Law

Most of Hong Kong's law derives from statute and is found in the Laws of Hong Kong in the form of Ordinances.²⁷⁸ According to Hong Kong tradition, much of Hong Kong's law is included in subsidiary legislation where the original legislation delegates to the executive body responsible for administering the law, the authority to create, in effect, by-laws.

(4) Chinese National Law

Several national laws of China apply in Hong Kong. These laws relate to defense, foreign affairs, and other matters that are outside the limits of the autonomy of Hong Kong.

(5) Chinese Customary Law

Chinese customary law and rights are recognized in Hong Kong under certain circumstances. For instance, the New Territories Ordinance (Cap. 97) permits the courts to acknowledge and apply pertinent aspects of Chinese customary law, particularly in land inheritance matters; the Legitimacy Ordinance (Cap. 184), recognizes Chinese law and custom.

(6) International Law

In accordance with Article 13 of the Basic Law, the Central Chinese Government retains control over foreign affairs; Hong Kong, however, as stated in Chapter VII, Article 151, may maintain and develop relations with states and organizations in the fields of economic affairs, trade, finance and monetary affairs, shipping, tourism, culture, and sports.²⁷⁹ Treaties do not have effect in Hong Kong until they are incorporated by legislation. International treaties and customary law may be

²⁷³ The Basic Law of The Hong Kong (July 2020 ed.),

https://www.basiclaw.gov.hk/en/basiclawtext/images/basiclaw_full_text_en.pdf.

²⁷⁴ The Law of the People's Republic of China on Safeguarding National Security in the Hong Kong Special Administrative Region 中华人民共和国香港特别行政区维护国家安全法, The National People's Congress of the People's Republic of China,

<http://www.npc.gov.cn/englishnpc/c23934/202009/eb3d12a9d34045f9a94de9a32d0d5433.shtml>.

²⁷⁵ See *Hong Kong security law: What is it and is it worrying?*, BBC (June 30, 2020), <https://www.bbc.com/news/world-asia-china-52765838>.

²⁷⁶ *Id.*

²⁷⁷ *Id.*

²⁷⁸ All legislation in force in Hong Kong is accessible on the internet at Hong Kong e-Legislation, <https://www.elegislation.gov.hk>.

²⁷⁹ The Basic Law of The Hong Kong (July 2020 ed.),

https://www.basiclaw.gov.hk/en/basiclawtext/images/basiclaw_full_text_en.pdf.

applied by courts as part of the common law. Over 260 international treaties and agreements have been applied to Hong Kong.

b) Political Structure in Hong Kong

The Hong Kong governance structure includes executive, legislative, and judicial branches. The Chief Executive, whose term of office runs for five years, is elected by an 800-person Election Committee and then appointed by the central Chinese government.²⁸⁰ While the ultimate aim for the Legislative Council, according to the Basic Law, is universal suffrage, it presently has 30 of its members elected by geographic and functional constituencies, 24 by universal suffrage, and 6 by the Election Committee.²⁸¹ The structure of the Hong Kong Judiciary includes the Court of Final Appeal, the High Court, which includes the Court of Appeal as well as the Court of First Instance, a variety of District Courts, and the Magistracy. There are also a variety of specialized tribunals.²⁸²

2. Lender Liability for Environmental Harm and Environmental Due Diligence

a) Lender Liability Under Environmental Legislation

(1) Environmental Regulatory Framework

Environmental law in Hong Kong is principally focused on controlling, preventing and/or remediating: 1) noise, 2) air, water and marine pollution, 3) waste disposal, and 4) contaminated land.²⁸³ There is currently no single statute governing environmental law in Hong Kong. Trade and industrial activities operate within the framework and standards set out in different statutes which are overseen by the relevant government department.²⁸⁴ This framework includes eight major statutes,

- 1) **Environmental Impact Assessment Ordinance (Cap. 499)** seeks to avoid, minimize, and control the adverse impact of designated projects set out in Schedule 2 of the statute. This statute introduces Environmental Impact Assessment process and environmental permit system.²⁸⁵
- 2) **Water Pollution Control Ordinance (Cap. 358)** oversees the discharge of effluent from industrial, commercial, institutional, and construction activities into public sewers, rainwater drains, river courses or water bodies.²⁸⁶

²⁸⁰ GovHK, Government Structure, <https://www.gov.hk/en/about/govdirectory/govstructure.htm> (last visited Oct. 3, 2020).

²⁸¹ *Id.*

²⁸² *Id.*

²⁸³ See Environmental Impact Assessment Ordinance, (1997) Cap. 499, § 29 (H.K.); Vicky Ma, *Lending and Taking Security in Hong Kong: Overview* (2019), https://1.next.westlaw.com/0-501-3182?_lrTS=20200819184601590&transitionType=Default&contextData=%28sc.Default%29.

²⁸⁴ *Id.*

²⁸⁵ See Environmental Impact Assessment Ordinance, (1998) Cap. 499 (H.K.), <https://www.elegislation.gov.hk/hk/cap499>. See also Christopher Tung, *Environmental law and Practice in Hong Kong: Overview* (May 1, 2019), [https://uk.practicallaw.thomsonreuters.com/3-503-4772?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/3-503-4772?transitionType=Default&contextData=(sc.Default)&firstPage=true) (providing a high-level overview of environment law and practice in Hong Kong).

²⁸⁶ See Water Pollution Control Ordinance, (1981) Cap. 358 (H.K.), <https://www.elegislation.gov.hk/hk/cap358>.

- 3) **Air Pollution Control Ordinance (Cap. 311)** imposes emissions controls and sets air quality objectives to control emissions from construction, commercial, and industrial works.²⁸⁷
- 4) **Waste Disposal Ordinance (Cap. 354)** sets out a comprehensive waste management protocol that covers the lifecycle of waste from the point of origination to the point of final disposal. This includes the production, storage, collection, treatment, recycling, and disposal of waste. Clinical waste, livestock waste and chemical waste are subject to specific controls and the import.²⁸⁸
- 5) **Noise Control Ordinance (Cap. 400)** regulates noise arising from various sources including construction, industrial, and commercial activities. Unless an approval has been granted through the Construction Noise Permit System, construction noise and the use of noisy equipment in populated areas is prohibited between certain hours from Monday to Saturday and on public holidays.²⁸⁹
- 6) **Hazardous Chemicals Control Ordinance (Cap. 595)** regulates the import, export, manufacture, and use of non-pesticide hazardous chemicals that have potentially harmful or adverse effects on human health or the environment through an activity-based permit system.²⁹⁰
- 7) **Dumping at Sea Ordinance (Cap. 466)** controls the disposal and dumping of substances and articles from vessels, aircraft, and marine structures in the sea.²⁹¹
- 8) **Ozone Layer Protection Ordinance (Cap. 403)** prohibits the manufacturing of ozone-depleting substances and controls the import, export, and production of these substances by requiring registration licenses from the Trade and Industry Department.²⁹²

b) Lender Liability Under Environmental Statutes

(1) Environmental Impact Assessment Ordinance (Cap. 499)

Under the Environmental Impact Assessment Ordinance (Cap. 499) (“EIAO”), liability falls on an individual or entity that fails to comply with, or breaches, the law. A holder of security over land is not liable for environmental damage provided the holder does not take possession of the land and does not cause, or knowingly permit, damage to the environment.²⁹³

According to the EIAO, a person may be criminally liable if that person constructs or operates a designated project without an environmental permit. Where a person convicted of an offence under the EIAO is a *body corporate*, and it is proved that the offence was committed with the consent

²⁸⁷ See Air Pollution Control Ordinance, (1983) Cap. 311 (H.K.), <https://www.elegislation.gov.hk/hk/cap311>.

²⁸⁸ Waste Disposal Ordinance, (1980) Cap. 354, <https://www.elegislation.gov.hk/hk/cap354>.

²⁸⁹ Noise Control Ordinance, (1989) Cap. 400 (H.K.), <https://www.elegislation.gov.hk/hk/cap400>.

²⁹⁰ Hazardous Chemicals Control Ordinance, (2008) Cap. 595 (H.K.), <https://www.elegislation.gov.hk/hk/cap595>.

²⁹¹ Dumping at Sea Ordinance, (1991) Cap. 466 (H.K.), <https://www.elegislation.gov.hk/hk/cap466>.

²⁹² Ozone Layer Protection Ordinance, (1989) Cap. 403 (H.K.), <https://www.elegislation.gov.hk/hk/cap403>. Other environmental statutes include: Product Eco-Responsibility Ordinance (Cap 603), Promotion of Recycling and Proper Disposal Ordinance, and Motor Vehicle Idling (Fixed Penalty) Ordinance (Cap. 611).

²⁹³ See Environmental Impact Assessment Ordinance, (1998) Cap. 499 (H.K.), <https://www.elegislation.gov.hk/hk/cap499>; Andrew MacGeoch, et al., *Real Estate 2020: Hong Kong*, Chambers & Partners, <https://practiceguides.chambers.com/practice-guides/real-estate-2020/hong-kong> (last updated Apr. 14, 2020).

of, or was attributable to any neglect on the part of a person concerned in the management of the body corporate, that person also commits the offence.²⁹⁴

Therefore, in general, as long as a lender holding or enforcing security over real estate or land does not participate in the operations or management of the borrower or security provider/guarantor or knowingly permit the operations that caused the contamination to the environment, a lender will not be subject to secondary liability for environmental damage in connection with that obligor's breach or failure to comply with the relevant legislation.²⁹⁵

However, the exercise of “step-in” rights on a security provider default may give rise to primary liability. That is, if the security is enforced, lenders as owners can be liable for environmental damage on or coming from the land, even if the lender did not cause such damage.²⁹⁶

(2) Water Pollution Control Ordinance (Cap. 358)

Similar to the EIAO, primary liability under the Water Pollution Control Ordinance (Cap. 358) (“WPCO”) falls on an individual or entity that fails to comply with, or breaches, the law. Specifically, the WPCO provides that:²⁹⁷

Liability of directors, etc.

(1) Where a person convicted of an offence under this Ordinance is a body corporate and it is proved that the offence was committed with the consent or connivance of, or was attributable to any neglect or omission on the part of, any director, manager, secretary or other person concerned in the management of the body corporate, the director, manager, secretary or other person also commits the offence.

(2) Where a person convicted of an offence under this Ordinance is a partner in a partnership and it is proved that the offence was committed with the consent or connivance of, or was attributable to any neglect or omission on the part of, any other partner or any person

²⁹⁴ See Environmental Impact Assessment Ordinance, (1997) Cap. 499, § 29 (H.K.). Section 29 states the following: 29. Directors of body corporate liable in certain circumstances

(1) Where a person convicted of an offence under this Ordinance is a body corporate and it is proved that the offence was committed with the consent or connivance of, or was attributable to any neglect or omission on the part of, a director, manager, secretary or other person concerned in the management of the body corporate, the director, manager, secretary or other person also commits the offence.

(2) Where a person convicted of an offence under this Ordinance is a partner in a partnership and it is proved that the offence was committed with the consent or connivance of, or was attributable to any neglect or omission on the part of, any other partner or any person concerned in the management of the partnership, the partner or the person concerned in the management also commits the offence.

²⁹⁵ See *id.* See also Andrew MacGeoch, et al., *Real Estate 2020: Hong Kong*, CHAMBERS & PARTNERS, <https://practiceguides.chambers.com/practice-guides/real-estate-2020/hong-kong> (last updated Apr. 14, 2020); Simon Reid-Kay, *Commercial real estate in Hong Kong: Overview* (Dec. 1, 2019), [https://1.next.westlaw.com/Document/I1e3f43fab84e11e498db8b09b4f043e0/View/FullText.html?contextData=\(sc.Default\)&transitionType=Default&ap_t1=1&firstPage=true&bhcp=1](https://1.next.westlaw.com/Document/I1e3f43fab84e11e498db8b09b4f043e0/View/FullText.html?contextData=(sc.Default)&transitionType=Default&ap_t1=1&firstPage=true&bhcp=1); Christopher Tung, *Environmental law and Practice in Hong Kong: Overview* (May 1, 2019), [https://uk.practicallaw.thomsonreuters.com/3-503-4772?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/3-503-4772?transitionType=Default&contextData=(sc.Default)&firstPage=true); Vicky Ma, *Lending and Taking Security in Hong Kong: Overview* (2019), https://1.next.westlaw.com/0-501-3182?__lrTS=20200819184601590&transitionType=Default&contextData=%28sc.Default%29.

²⁹⁶ See Andrew MacGeoch, et al., *Real Estate 2020: Hong Kong*, Chambers & Partners, <https://practiceguides.chambers.com/practice-guides/real-estate-2020/hong-kong> (last updated Apr. 14, 2020).

²⁹⁷ See Water Pollution Control Ordinance, (1981) Cap. 358, § 10A (H.K.).

concerned in the management of the partnership, the partner or the person concerned in the management also commits the offence.

(3) *Waste Disposal Ordinance (Cap. 354)*

Like the EIAO and WPCO, primary liability incurred under the Waste Disposal Ordinance (Cap. 354) (“WDO”) falls on an individual or entity that fails to comply with, or breaches, the law. Specifically, the WDO provides that:²⁹⁸

39. Liability of directors, etc.

(1) Where a person convicted of an offence under this Ordinance is a body corporate and it is proved that the offence was committed with the consent or connivance of, or was attributable to any neglect or omission on the part of, any director, manager, secretary or any other person concerned in the management of the body corporate, the director, manager, secretary or other person also commits the offence.

(2) Where a person convicted of an offence under this Ordinance is a partner in a partnership and it is proved that the offence was committed with the consent or connivance of, or was attributable to any neglect or omission on the part of, any other partner or any other person concerned in the management of the partnership, the partner or other person also commits the offence.

In practice, lenders often aim to protect themselves against potential environmental liability by carrying out environmental due diligence checks.²⁹⁹ If any remediation is required or non-compliance is found, the lender may require remediation to be undertaken or non-compliance to be rectified within a specified timeframe.³⁰⁰ In addition, loan agreements often include representations, warranties, and indemnities that provide that the borrower has complied with all legal requirements and best industry practices (including environmental regulations and standards), the breach of which will result in an event of default, giving the lender the option to accelerate repayment of the loan.³⁰¹ A lender may also minimize liability by making it a condition precedent for an advance of funds for the borrower to have previously settled any such liability to the lender’s satisfaction as well as obliging the borrower to obtain environmental insurance to protect the borrower against particular environmental risks.³⁰² Lenders may also take out their own insurances.³⁰³

c) *Environmental Due Diligence*

Currently, there is no comprehensive legal framework regulating environmental due diligence in Hong Kong. However, the Hong Kong government has made progress in recent years on corporate

²⁹⁸ See Waste Disposal Ordinance, (1980) Cap. 354, § 39 (H.K.).

²⁹⁹ Andrew MacGeoch, et al., *Real Estate 2020: Hong Kong*, Chambers & Partners, <https://practiceguides.chambers.com/practice-guides/real-estate-2020/hong-kong> (last updated Apr. 14, 2020).

³⁰⁰ See Christopher Tung, *Environmental law and Practice in Hong Kong: Overview* (May 1, 2019), [https://uk.practicallaw.thomsonreuters.com/3-503-4772?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/3-503-4772?transitionType=Default&contextData=(sc.Default)&firstPage=true).

³⁰¹ *Id.*

³⁰² *Id.*

³⁰³ *Id.*

social responsibility (“CSR”), advancing the concept beyond corporate philanthropy to responsibility to conduct due diligence on a range of non-financial concerns. Termed collectively as environment, social and governance (“ESG”), these concerns have gained growing prominence, particularly on the importance of fostering a green economy.

(1) *The Environmental, Social, and Governance Regulatory Framework for Listed Company*

The Hong Kong Exchanges and Clearing Limited (“HKEx”) has been promoting corporate social responsibility practices and sustainable investment in Hong Kong market. HKEx has provided *Environmental, Social, and Governance Reporting Guide* to listed companies on the Hong Kong Stock Exchange (“SEHK”), including commercial banks.³⁰⁴ The Guide covers four areas: workplace quality, environmental protection, operating practices, and community involvement.³⁰⁵

The HKEX first introduced the Environmental, Social, and Governance (“ESG”) reporting guide in 2012 as “Recommended Practice” for the disclosure of the ESG information (i.e. on a *voluntary* basis).³⁰⁶ In 2016, the HKEX made it *compulsory* for companies to release details on ESG practice following a market consultation.³⁰⁷ In December 2019, the HKEX issued stricter and more demanding requirements for ESG reporting for listed companies, aiming to raise the standard of ESG reporting by Hong Kong companies to the global level.³⁰⁸

Under the 2019 new rules, listed companies, including commercial banks listed in Hong Kong, must publish mandatory ESG reports that include disclosures on their environmental practice, including significant climate-related issues which may impact the company;³⁰⁹ practices used to identify environmental risks along the supply chain;³¹⁰ and practices used to promote environmentally preferable products and services when selecting suppliers.³¹¹ If the company fails to report on one or more of the “comply or explain” provisions, it must provide considered reasons in its ESG report.³¹² The key change in the ESG reporting is the *mandatory* disclosure of governance structure to strengthen board involvement in managing ESG issues.³¹³ Specifically, key reporting requirements include mandatory disclosure of a board statement setting out the

³⁰⁴ Appendix 27 Environmental, Social and Governance Reporting Guide, Hong Kong Exchanges and Clearing <https://en-rules.hkex.com.hk/node/3841> (last visited Sept. 15, 2020). See also Yichen Shi et al., *Listed Banks: ESG Development Process and Future Trends* 上市银行 ESG 发展进程及未来趋势, XINHUA (Aug. 15, 2019), <http://greenfinance.xinhua08.com/a/20190815/1883142.shtml>.

³⁰⁵ Appendix 27 Environmental, Social and Governance Reporting Guide, Hong Kong Exchanges and Clearing <https://en-rules.hkex.com.hk/node/3841> (last visited Sept. 15, 2020).

³⁰⁶ Analysis of Environment, Social and Governance Practice Disclosure in 2016/2017, HKEX 3 (May 2018), https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Environmental-Social-and-Governance/Exchange-Publications-on-ESG/esgreport_2016_2017.pdf?la=en.

³⁰⁷ *Id.*

³⁰⁸ Appendix 27 Environmental, Social and Governance Reporting Guide, Hong Kong Exchanges and Clearing <https://en-rules.hkex.com.hk/node/3841> (last visited Sept. 15, 2020).

³⁰⁹ *Id.* at A27 – 7.

³¹⁰ *Id.* at A27 – 9.

³¹¹ *Id.*

³¹² *Id.* at A27 – 1.

³¹³ *Id.* at A27 – 4.

board's consideration of ESG matters; application of Reporting Principles "materiality", "quantitative," and "consistency"; explanation of reporting boundaries of ESG reports.³¹⁴

With respect to liability for non-compliance, companies that fail to submit the report will be in breach of the listing rules and could potentially put their listing in jeopardy.³¹⁵ Non-compliance could also possibly tarnish their reputation in the investing community, potentially affecting the share price, and among civil society, activist groups and current and would-be employees.³¹⁶

(2) *Sustainable Banking and Green Finance*

The Hong Kong Monetary Authority ("HKMA"), the *de facto* central bank in Hong Kong, has also been promoting Sustainable Banking and Green Finance in order to address potential environmental harm and risk that might arise in banking activities. Given the HKMA's role as a banking regulator, its primary focus is on the risks posed by issues such as climate change to banks, and how these risks can be managed. The HKMA aims to facilitate the development of businesses and to promote corporate social responsibility in relation to climate change mitigation and adaption; ultimately to "get all banks on board to go green."³¹⁷

The HKMA aims to address climate-related issues in two respects, covering the financial impacts and the environmental and social impacts. Financial impacts concern the effects, which can be positive or negative, of climate change on the value and financial health of banks. Environmental and social impacts concern the effects of banking activities on the environment. Bank operations and, more importantly, the activities they finance, may accelerate or mitigate climate change.³¹⁸ Under this newly developed initiative, ethics committees of financial institutions would look closely at environmental issues before lending funds to a particular entity/individual or investing in a particular project.³¹⁹

The HKMA adopts a three-phased approach to promote green and sustainable banking.³²⁰ During phase one, it plans to develop a common framework to assess the "Greenness Baseline" of individual banks.³²¹ The HKMA will also collaborate with relevant international bodies to provide technical support to banks in Hong Kong to better understand the green principles and methodology in undertaking the baseline assessment.³²² At phase two, the major focus is the

³¹⁴ *Id.*

³¹⁵ CFO Innovation Staff, *Sustainability Reporting: Crunch Time in Hong Kong and Singapore*, CFO INNOVATION (Nov. 7, 2016 5:53pm), <https://www.cfoinnovation.com/accounting-compliance/sustainability-reporting-crunch-time-hong-kong-and-singapore>.

³¹⁶ *Id.*

³¹⁷ See White Paper on Green and Sustainable Banking, HONG KONG MONETARY AUTHORITY 6 (2020), <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2020/20200630e1a1.pdf>. See also Understanding Climate Driven Financial Risks and their Management, Hong Kong Green and Sustainable Banking Webinar (August 20, 2020).

³¹⁸ See White Paper on Green and Sustainable Banking, HONG KONG MONETARY AUTHORITY 6 (2020), <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2020/20200630e1a1.pdf>.

³¹⁹ *Id.*

³²⁰ *Id.* at 17–18.

³²¹ See White Paper on Green and Sustainable Banking, HONG KONG MONETARY AUTHORITY (2020), <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2020/20200630e1a1.pdf>.

³²² *Id.*

development of supervisory expectations and requirements. The HKMA will engage the industry and other relevant stakeholders in a consultation on the supervisory expectation or requirement on Green and Sustainable Banking, with a view to setting tangible deliverables for promoting the green and sustainable developments of the Hong Kong banking industry.³²³ At phase three, HKMA will set green and sustainable targets, and implement, monitor and evaluate the progress of banks toward these targets.³²⁴

However, while the framework does encourage banks to develop sustainability-related business, the primary goal of this initiative is to build a resilient banking system and to mitigate financial risks posed by climate change to banks, rather than fostering environmental sustainability. For instance, climate change could generate significant risks to banks' portfolios, such as farm loans not being repaid because of poor crop yields following droughts or utility companies defaulting amid new legislation on carbon emissions.³²⁵ Under the framework, banks are not effectively expected to manage their impact on climate or biodiversity as long as that impact is not financially material to them.³²⁶ The HKMA framework does not require large banks to make known their impacts on the environment and society, for instance it does not require banks to consider disclosing information about their lending portfolio contributing to climate change mitigation and adaptation.³²⁷ Importantly, ***it does not impose any legal responsibility for environmental harms by the investors or borrowers.*** For Hong Kong's sustainable banking to live up to its name, more consideration should be given to banks' management of their environmental and social impact so it can mitigate the sustainability risks facing its economy and banking system.³²⁸

3. *Lender Liability for Social Harm*

Hong Kong has a relatively established legal framework in prohibiting social harms that might arise in corporate activities, including those of commercial banks. This framework includes the following major statutes:

a) *Bill of Rights Ordinance (Cap. 383)*

Article 4 of the Hong Kong Bill of Rights Ordinance prohibits slavery, slave-trade in all forms, forced labor, domestic servitude, and human trafficking, and accordingly imposes liability on corporations that commit offences.³²⁹ However, there are no criminal sanctions against forced or

³²³ *Id.*

³²⁴ *Id.*

³²⁵ See Johnson Kong & Serena Chow, *Hong Kong Banks Must Do More to Reduce Their Impact On Climate Change, Not Just Avoid Risk*, South China Morning Post (Aug19, 2020, 10:17pm), <https://www.scmp.com/comment/article/3097939/hong-kong-banks-must-do-more-reduce-their-impact-climate-change-not-just>.

³²⁶

³²⁷ *Id.*

³²⁸ *Id.*

³²⁹ See Bill of Rights Ordinance, (1991) Cap. 383, art. 4 (H.K.), https://www.elegislation.gov.hk/hk/cap383?SEARCH_WITHIN_CAP_TXT=slavery. Article 4 of the statute states the following:

Article 4. No slavery or servitude

(1) No one shall be held in slavery; slavery and the slave-trade in all their forms shall be prohibited.

(2) No one shall be held in servitude.

(3) (a) No one shall be required to perform forced or compulsory labour. (b) For the purpose of this paragraph the term "forced or compulsory labour" shall not include—

compulsory labor, servitude or human trafficking.³³⁰ There are no victim protection provisions in this legislation either.³³¹

b) Crimes Ordinance (Cap. 200)

Crimes Ordinance (Cap. 200) provides extra-territorial effect against certain sexual offences committed by corporations, including commercial banks, against children outside Hong Kong.³³² These offences are listed in a schedule to the ordinance:³³³

c) Human Organ Transplant Ordinance (Cap. 465)

This Ordinance prohibits commercial dealings in human organs.³³⁴

d) Employment Ordinance (Cap. 57)

Employment Ordinance imposes criminal and civil liability on corporate employers involved in non-payment, under-payment of wages or delay in payment of wages, failure to grant rest days, and statutory holidays to employees.³³⁵

-
- (i) any work or service normally required of a person who is under detention in consequence of a lawful order of a court, or of a person during conditional release from such detention;
 - (ii) any service of a military character and, where conscientious objection is recognized, any national service required by law of conscientious objectors;
 - (iii) any service exacted in cases of emergency or calamity threatening the life or well-being of the community;
 - (iv) any work or service which forms part of normal civil obligations.

³³⁰ *Id.*

³³¹ *Id.*

³³² *Id.* The Crimes Ordinance states the following:

153P. Extra-territorial effect of sexual offence provisions listed in Schedule 2

(1) Where— (a) (i) a person who is a Hong Kong permanent resident or who ordinarily resides in Hong Kong; (ii) a body corporate that is incorporated or registered in Hong Kong; or (iii) a body of persons, whether corporate or unincorporate, that has a place of business in Hong Kong, commits any act outside Hong Kong; and (b) the act— (i) would have constituted an offence under any of the provisions specified in Schedule 2 had it been committed in Hong Kong; and Last updated date 5.12.2014 Crimes Ordinance Part XII 12-108 Section 153P Cap. 200 (ii) is committed in relation to a person under the age of 16 or, in the case of an offence under section 123 or 140, under the age of 13, then the person or body shall be guilty of that offence.

(2) Where any person or body of persons, whether corporate or unincorporate, commits any act outside Hong Kong that— (a) would have constituted an offence under any of the provisions specified in Schedule 2 had it been committed in Hong Kong; and (b) is committed in relation to a person who is a Hong Kong permanent resident or who ordinarily resides in Hong Kong and is— (i) under the age of 16; or (ii) in the case of an offence under section 123 or 140, under the age of 13, then the person or body shall be guilty of that offence.

³³³ *Id.* Schedule 2.

³³⁴ See Hong Kong Human Organ Transplant Ordinance (, (1996) Cap. 465), <https://www.elegislation.gov.hk/hk/cap465> (last visited Oct., part 3, 2020 (H.K.)), <https://www.elegislation.gov.hk/hk/cap465>. The statute states the following:

4. Prohibition of commercial dealings in human organs

(2) A person is guilty of an offence if he takes part in the management or control of a body of persons corporate or unincorporate whose activities consist of or include the initiation or negotiation of any arrangements referred to in subsection (1)(c).

³³⁵ See Employment Ordinance, 1968 (Cap. 57), (H.K.). <https://www.elegislation.gov.hk/hk/cap57>. The statute states the following:

43Q. Liability of directors, partners, etc. for offence under section 43P

(1) Where an offence under section 43P committed by a body corporate is proved to have been committed with the consent or connivance of, or to be attributable to any neglect on the part of, any director, manager, secretary or other

4. *Human Rights Due Diligence*

Currently, there is no legislation in force in Hong Kong which mandates disclosure of human rights risk for businesses. Instead, due diligence in Hong Kong mainly focuses on anti-money laundering, drug trafficking, and anti-terrorism.

Nevertheless, there is a current trend towards establishing legal frameworks on disclosure of human rights risk for businesses. This section examines the initiatives that Hong Kong has taken to develop the law on human rights due diligence for businesses, the most important ones including the Environmental, Social, and Governance Regulatory Framework for Listed Company as well as the Modern Slavery Bill of 2017.

a) *The Environmental, Social, and Governance Regulatory Framework for Listed Company*

In addition to mandatory disclosure of environmental information under the ESG Reporting Guide, HKEx also demands disclosure of information on certain social practices of listed companies, which for example employment and labor standards (e.g. child and forced labor).³³⁶ Listed companies are advised to conduct due diligence to prevent child or forced labor within its activities and to avoid contributing to or becoming linked with the use of child and forced labor through its relationships with others (e.g. suppliers, clients).³³⁷ However, the “comply or explain” approach is only provided for some social key performance indicators and not for all social impacts. For example, the rules for reporting child and forced labor are only recommended rather than mandatory.³³⁸

b) *Hong Kong Modern Slavery Bill of 2017*

• *Legislative History*

Currently, there is no modern slavery legislation in force in Hong Kong which mandates disclosure of human rights risks for businesses. In recent years, however, concerns regarding the lack of a proper legislative framework addressing modern slavery and human trafficking have been raised in Hong Kong. In this respect, Hong Kong is seen to be lagging behind its neighbors—Macau

similar officer of the body corporate, the director, manager, secretary or other similar officer commits the like offence. (2) Where an offence under section 43P committed by a partner in a firm is proved to have been committed with the consent or connivance of, or to be attributable to any neglect on the part of, any other partner in the firm or any other person concerned in the management of the firm, the other partner or the other person concerned in the management of the firm commits the like offence.

(3) An offence under section 43P committed by a body corporate is presumed to have been committed with the consent or connivance of, or to be attributable to the neglect on the part of, any director, manager, secretary or other similar officer of the body corporate, if it is proved that, at the time the offence was committed, the director, manager, secretary or other similar officer— (a) was concerned in the management of the body corporate; or (b) knew or ought to have known that the award of the tribunal in respect of which the offence was committed had been made against the body corporate.

³³⁶ Appendix 27 Environmental, Social and Governance Reporting Guide, Hong Kong Exchanges and Clearing at A27 – 9, <https://en-rules.hkex.com.hk/node/3841>.

³³⁷ *Id.*

³³⁸ *Id.*

having approved an anti-human trafficking law in 2008³³⁹ and mainland China having implemented steps to combat human trafficking under its 2013-2020 National Action Plan.³⁴⁰ For this reason, an anti-human trafficking concern group comprising NGOs and legal professionals has urged the Hong Kong government to take immediate steps to criminalize all forms of human trafficking.

In November 2017, Dennis Kwok, a member of Hong Kong's Legislative Council, along with other legal experts, presented a draft Modern Slavery Bill (the "Draft Bill") to the Chief Executive for consideration.³⁴¹ The Draft Bill is modelled after the Modern Slavery Act 2015 of the United Kingdom (the "U.K. Act") with some modifications³⁴² and follows similar legislation in Australia. In a letter to the Legislative Council of Hong Kong, Legislative Council members Dennis Kwok and Kenneth Leung expressed concern that Hong Kong has been placed on the Tier 2 Watch List in the Trafficking in Persons Report of the U.S. State Department in 2016 and 2017 due to the lack of effective laws to combat human trafficking.³⁴³ They recognized that Hong Kong's laws fail to "meet the minimum global standard" for addressing modern slavery, and argued that Hong Kong's continued lack of efficacy in combatting human trafficking may result in Hong Kong being "further named and shamed or even sanctioned."³⁴⁴

The Draft Bill was discussed at a meeting of the Panel of Security of the Legislative Council on June 5, 2018, but the parties did not reach a consensus.³⁴⁵ The discussion is to continue at a later date, although the Legislative Council did not specify a timetable. Overall, there is little support within the Hong Kong government for a new slavery law. The government believes that criminal offences associated with human trafficking are already sufficiently addressed by existing legislation, the Plan of Action to tackle similar issues already exists, and that victim numbers in Hong Kong are very limited.³⁴⁶ Nevertheless, lawmaker Dennis Kwok has lobbied international actors, including the United Nations, to put pressure on city officials.³⁴⁷

- ***Purpose of the Draft Bill***

The stated purposes of the Draft Bill are threefold: (1) to give effect to Article 4 of the Hong Kong Bill of Rights, which prohibits slavery and slave-trade in all their forms, forced labor, domestic

³³⁹ Macau: Combat the crime of trafficking in persons (Law No. 6/2008), http://www.anti-tip.gov.mo/images/6_2008.pdf.

³⁴⁰ State Council General Office Notice on Issuance of China's Action Plan Against Human Trafficking, [2013] No. 19 中国反对拐卖人口行动计划（2013—2020 年）, http://www.nwccw.gov.cn/2017-05/26/content_158795.htm.

³⁴¹ The Modern Slavery Bill of Hong Kong (2017), <https://www.legco.gov.hk/yr17-18/chinese/panels/se/papers/se20180605cb2-1480-5-ec.pdf>.

³⁴² *Id.*

³⁴³ Letter from Dennis Kwok and Kenneth Leung, Legislative Council members, to Hon. Hak-kan Chan, Chairman of the Panel on Security, Legislative Council of Hong Kong (Jan. 11, 2018), <https://www.legco.gov.hk/yr17-18/chinese/panels/se/papers/secb2-765-1-ec.pdf>.

³⁴⁴ *Id.*

³⁴⁵ Panel on Security Meeting (June 5, 2018), <https://www.legco.gov.hk/yr17-18/english/panels/se/agenda/se20180605.htm>.

³⁴⁶ Bonny Lin, *How New Rules Aim To Reduce Slave Labor In Asia*, Asia Global Online (May 9, 2019), <https://www.asiaglobalonline.hku.hk/human-trafficking-in-asia>.

³⁴⁷ Beh Lih Yi, *Hong Kong: Lawmakers Push for Anti-Slavery Law*, Business & Human Rights Resource Centre (Jan. 9, 2019), <https://www.business-humanrights.org/en/hong-kong-lawmakers-push-for-anti-slavery-law>.

servitude, and human trafficking; (2) to give effect to Article 1 of the United Nations' Supplementary Convention on the Abolition of Slavery of 1957, which prohibits forced marriage; and (3) to provide protection for victims of slavery and trafficking.³⁴⁸

- **Content of the Draft Bill**

- a. Criminalization Proposal

The Draft Bill would amend the Crimes Ordinance (Cap. 200) by repealing the existing offence of trafficking for the purpose of prostitution and creating new criminal³⁴⁹ and civil offences relating to human trafficking, slavery, servitude, forced labor, forced marriage, and sex tourism.³⁵⁰ The scope of these new criminal and civil offenses would be broader. The Draft Bill states that these offenses can be committed by “persons,” which include *any body of persons, corporate or unincorporated*. Therefore, a company, or even its individual directors, employees, or agents may be charged with the commission of these various offenses.

The Draft Bill also includes a range of other measures such as the establishment of an independent anti-slavery Commission, a requirement of transparency in supply chains modelled along the lines of the U.K. Act,³⁵¹ civil preventative orders, a civil action to be brought by human trafficking victims: The Draft Bill contains further proposals providing potential claimants with a civil cause of action in tort against perpetrators or others who knowingly benefitted financially, or received anything of value, through involvement in a venture that they knew, or should have known, would involve slavery. These causes of action potentially extend the ambit and power of the Bill beyond the U.K. Act and accordingly could raise standards further for businesses managing global supply chains through harmonized risk management approaches and systems.³⁵² If passed, this would be

³⁴⁸ The Modern Slavery Bill of Hong Kong (2017), <https://www.legco.gov.hk/yr17-18/chinese/panels/se/papers/se20180605cb2-1480-5-ec.pdf>.

³⁴⁹ In early 2018, two Legislative Council members, Dennis Kwok and Kenneth Leung, proposed legislation to criminalize all forms of human trafficking in Hong Kong. See Letter from Dennis Kwok and Kenneth Leung, Legislative Council members, to Hon. Hak-kan Chan, Chairman of the Panel on Security, Legislative Council of Hong Kong (Jan. 11, 2018), <https://www.legco.gov.hk/yr17-18/chinese/panels/se/papers/secb2-765-1-ec.pdf>.

³⁵⁰ The Modern Slavery Bill of Hong Kong (2017), <https://www.legco.gov.hk/yr17-18/chinese/panels/se/papers/se20180605cb2-1480-5-ec.pdf>.

³⁵¹ See United Kingdom Modern Slavery Act 2015, <https://www.legislation.gov.uk/ukpga/2015/30/contents/enacted> (last visited Oct. 3, 2020).

³⁵² The Hong Kong Draft Bill goes much further than the U.K. Act or the Australian Act in that section 169 provides claimants with a civil cause of action in tort against any person (individual or company) who has: (a) committed one of the offences under the Hong Kong Bill against them; or (b) knowingly benefited, financially or by receiving anything of value from participation in a venture which that person knew or should have known has engaged in an act in violation of the Hong Kong Bill. This section is derived from §1595 of 18 U.S. Code Chapter 77 (Peonage, Slavery, and Trafficking in Persons). However, although section 169(a) is designed for claimants who have themselves suffered at the hands of human traffickers, section 169(b), as drafted, does not currently specify what sort of claimant will be given standing, begging the question of whether, for example, an NGO can bring an action under section 169(b) unilaterally. Moreover, it remains open whether section 169(b) could extend liability to defendants who, for example, benefit financially from their subsidiaries' operations, but would not otherwise owe a duty of care to victims. This is particularly an issue for larger companies, which may be deemed to have the requisite “knowledge” under section 169(b) by virtue of carrying out due diligence in preparation for meeting their reporting obligations under section 189.

Although section 169 does not expressly stipulate the types of damages which victims of slavery and human trafficking can seek, in light of the application of the equivalent provision in the U.S., it is expected that civil

likely to have a serious effect on how businesses address human rights issues in their operations and supply chains.

- **Corporate Disclosure**

As mentioned above, the Draft Bill contains a corporate reporting obligation under section 189, which is nearly identical to section 54 of the U.K. Act. Under the proposed law, a commercial organization doing business in Hong Kong over a certain size would be required to publish a slavery and human trafficking statement each year which sets out the steps it has taken to ensure there is no slavery or trafficking in its supply chains or its own business, or states that it has taken no such steps. This section takes a closer look at the corporate disclosure requirement and its implications for companies.

- a. Which companies are covered under the draft bill?

As for the requirement to publish a “slavery and human trafficking statement,” the Draft Bill covers any “body corporate” or partnership—wherever it is incorporated—that conducts “business or part of a business in Hong Kong.”³⁵³ Thus, any company—regardless of its citizenship—that operates in Hong Kong may be covered under the Draft Bill. While the companies may have to meet a “total turnover” threshold to be covered, that threshold is not currently defined, as the Draft Bill directs the Chief Executive to publish regulations on that issue. Under the current proposal, commercial banks will likely be covered under the Draft Bill.

- b. What do covered companies need to do?

The Draft Bill, if enacted, would require covered companies to prepare a “slavery and human trafficking statement” every financial year. This Statement would require companies to outline the steps they have taken during the financial year to ensure that slavery and human trafficking is “not taking place in any of its supply chains, and in any part of its own business.”³⁵⁴ Alternatively, companies would have to submit a Statement that they have not taken any steps at all. If the company has a website, then the Statement must be prominently published on the website’s homepage. If the company does not have a website, then a copy of the Statement must be provided to anyone who makes a written request for it, within 30 days of the date of receipt of such request.³⁵⁵

damages under section 169 could cover both pecuniary and non-pecuniary loss such as emotional harm, pain and suffering, inconvenience, and mental anguish. Punitive damages may also be awarded to punish the defendants and deter future illegal conduct. *See* Modern slavery and human trafficking—a comparative analysis of existing and emerging legislation: United Kingdom, Australia, Hong Kong, and Singapore, Norton Rose Fulbright (March 2018), <https://www.nortonrosefulbright.com/en/knowledge/publications/14437396/modern-slavery-and-human-trafficking--a-comparative-analysis-of-existing-and-emerging-legislation-in-the-united-kingdom-australia-hong-kong-and-singapore>.

³⁵³ The Modern Slavery Bill of Hong Kong (2017), <https://www.legco.gov.hk/yr17-18/chinese/panels/se/papers/se20180605cb2-1480-5-ec.pdf>.

³⁵⁴ *Id.*

³⁵⁵ *Id.*

However, the Draft Bill does not define the phrase “supply chains.” The term “supply chain” is thought to present operational and definitional challenges.³⁵⁶ For example, this lack of definition raises the question as to whether the Draft Bill will require covered companies to report on steps taken with regard to only “first-tier” business partners with whom the companies direct contractual relationships, or whether other business partners need also be considered.

By creating this Statement requirement,³⁵⁷ the Draft Bill joins the ranks of other similar national laws in U.K, U.S., and Australia that require such disclosures, placing market pressure on companies to prevent, identify, and eliminate modern slavery practices in companies’ operations and among business partners. The Statement must be approved by the board of directors (or equivalent management body) and signed by a director (or a general partner in the case of limited partnership).

The Chief Executive may bring civil proceedings against a non-compliant company in the Hong Kong High Court for any order of injunction for specific performance. An entity that fails to comply with the injunction order will be found guilty of contempt of court. However, there would be no financial penalty for non-compliance.³⁵⁸

5. Conclusions on Hong Kong Lender Liability for Environmental and Social Harm and Human Rights Due Diligence

Overall, the legal framework in which lender liability is contemplated for environmental and social harm in Hong Kong is not as comprehensive as those of the U.S. or UK and is still developing. With respect to environmental harms, lender liability is mainly governed by statutory law and government regulations. The current law may make pursuing liability for lenders difficult. Under the environmental legislation, including Environmental Impact Assessment Ordinance (Cap.499), Water Pollution Control Ordinance (Cap. 358), and Waste Disposal Ordinance (Cap. 354), ***a lender is unlikely to be subject to liability for environmental damage in connection with borrower’s failure to comply with the relevant legislation, as long as a lender holding or enforcing security over real estate or land does not participate in the operations or management of the borrower or security provider/guarantor, or knowingly permit the operations that caused the contamination to the environment.*** However, the exercise of “step-in” rights on a security provider default may give rise to primary liability. In practice, lenders often may protect themselves against potential environmental liability by implementing a broad range of

³⁵⁶ See Michael G. Congiu, Stefan Marculewicz & Lavanga Wijekoon, *Hong Kong Considers Draft Law Requiring Companies to Report on Modern Slavery*, LITTLER (Apr. 17, 2018), <https://www.jdsupra.com/legalnews/hong-kong-considers-draft-law-requiring-38486/>.

³⁵⁷ The Bill does not mandate the disclosure of any specific information on the “steps” a company takes to ensure that slavery and human trafficking is not taking place in its operations and the operations of suppliers. Instead, the Statement “may” include information about (i) The company’s structure, its business and its supply chains; (ii) its policies in relation to slavery and human trafficking; (iii) its due diligence processes in relation to slavery and human trafficking in its business and supply chains; (iv) the parts of its business and supply chains where there is a risk of slavery and human trafficking taking place, and steps taken to assess and manage that risk; (v) its effectiveness in ensuring that slavery and human trafficking is not taking place in its business or supply chains, measured against such performance indicators as it considers appropriate; and (vi) trainings about slavery and human trafficking available to its staff.

³⁵⁸ *Id.*

precautionary measures, carrying out environmental due diligence checks, and purchasing environmental insurance.

In recent years, the Hong Kong governmental agencies have taken initiatives encouraging, and in some circumstances mandating companies to conduct environmental due diligence for their businesses. For instance, under the *Environmental, Social and Governance Reporting Guide*, listed companies on the Hong Kong Stock Exchange, including commercial banks, must publish mandatory ESG reports that include disclosures on their environmental practice, including significant climate-related issues which may impact the company; practices used to identify environmental risks along the supply chain; and practices used to promote environmentally preferable products and services when selecting suppliers. If the company fails to report on one or more of the “comply or explain” provisions, it must provide considered reasons in its ESG report. ***With respect to liability for non-compliance, companies that fail to submit the report will be in breach of the listing rules and could put their listing in jeopardy. Non-compliance could also possibly tarnish their reputation in the investing community, potentially affecting the share price, and among civil society, activist groups and current and would-be employees. However, commercial banks are not likely to be held legally liable under this framework for their non-compliance of reporting.*** Additionally, the Hong Kong Monetary Authority has been also promoting *Sustainable Banking and Green Finance* to address potential environmental impacts of banking activities. While this framework encourages banks to develop sustainability-related business, the regulatory focus remains on climate-related risks. Under this framework, banks are not expected to manage their impact on climate, biodiversity, or other environmental impact as long as that impact is not financially material to them. The framework does not require banks to consider disclosing information about their lending portfolio contributing to climate change mitigation and adaptation. Therefore, there is no enforcement or sanction mechanism built in the framework. .

On social harms, Hong Kong prohibits certain social harms that might arise in corporate activities, (including those of commercial banks) and imposes potential civil/criminal sanctions on corporations. This framework includes the following major statutes: Bill of Rights Ordinance (Cap. 383), Crimes Ordinance (Cap. 200), Human Organ Transplant Ordinance (Cap. 465), and Employment Ordinance (Cap. 57). ***However, these statutes do not specifically address liability of commercial banks or private lenders. Thus, it is unclear whether commercial banks could be held liable for social harm caused by the money they loaned.***

There is a continuing trend towards establishing legal frameworks towards mandatory disclosure of human rights risks by corporations, including commercial banks. For instance, under the ESG Reporting Guide of HKEx, listed companies, including commercial banks, are required to disclose information on certain social practice, which for example covers employment, labor standards (e.g. child and forced labor), etc. For instance, listed companies are advised to conduct due diligence to prevent child and forced labor within its activities and to avoid contributing to or becoming linked with the use of child and forced labor through its relationships with others (e.g. suppliers and clients). However, the “comply or explain” approach is only imposed for some social key performance indicators and not all social impacts. For instance, the rules for reporting child and forced labor are only recommended, not mandatory. Similar to the sanction mechanism of non-compliance regarding environmental due diligence, companies that

fail to submit the report theoretically will be in breach of the listing rules and could put their listing in jeopardy. Non-compliance could also possibly tarnish their reputation in the investing community, potentially affecting the share price, and among civil society, activist groups and current and would-be employees. Furthermore, the Hong Kong legislature is currently considering draft legislation which, if enacted, would require certain companies—including those incorporated outside of Hong Kong—to publish a “slavery and human trafficking statement.” Under the current proposal, commercial banks would likely be covered under the Draft Bill.

The Hong Kong Draft Modern Slavery Bill goes further than the U.K. Act in that it creates a host of criminal and civil offenses related to modern slavery and empowers courts to issue orders to prevent certain corporations from committing those offenses. If enacted, this Draft Bill would add to the increasingly complex landscape of national laws that place direct obligations on companies to identify and eliminate modern slavery from their own operations and from the operations of those companies’ business partners.

C. Other Jurisdictions

In addition to the three jurisdictions discussed in some detail above, a survey of four additional jurisdictions is provided below containing a summary of the circumstances in which lenders may be held liable for harm caused to third parties, with particular focus on liability for environmental harm. These jurisdictions include: Australia, Brazil, Canada and New Zealand.

As with the States discussed in Sections II(A) – II(C), we find that the mere act of lending will not suffice to create lender liability for harms caused by the borrowers to whom it grants credit. In general, liability generally only arises if the lender (1) had control over the borrowers at the time of the harm occurring; or (2) disbursed funds and thereby caused or knowingly permitted the eventual harms to occur.

1. Australia

Australian company legislation contains provisions on shadow directors, and courts have regarded banks as shadow directors in some situations. Section Nine of the Corporations Act 2001 states that the term ‘director’ also refers to a person not elected as a director, *inter alia*, if the directors of the company are accustomed to act according to the person’s instructions.³⁵⁹

a) *Buzzle Operations Pty Ltd (In Liq) v Apple Computers Australia Pty Ltd*

The case of *Buzzle Operations Pty Ltd (In Liq) v Apple Computers Australia Pty Ltd* [2011] NSWCA 109 (“*Buzzle*”) ***provides guidance on when a creditor or financier would be considered a shadow director of a company.*** The case was an appeal which arose from the insolvency of Buzzle Operations Pty Ltd. Buzzle was formed by the merger of six Apple resellers, who all had contracts with Apple and had granted security. Apple had set financial and other expectations clear to Buzzle, and Apple exerted significant influence on the directors of the company, to the extent where the directors felt like they had to comply with Apple’s directions. Buzzle then became insolvent, and the liquidator made a claim against Apple, as the liquidator stated that Apple was acting as a shadow director. The Court found that Apple was not a shadow director, and laid out some factors that need to be proven to find that someone is a shadow director.³⁶⁰

The elements are:³⁶¹

1. A connection between the shadow director’s instructions and the company’s eventual actions.
2. The majority of the board habitually complied with the shadow director’s instructions (i.e. a pattern of compliance). However, it is unnecessary to show that the directors did not exercise any decision making.
3. The instructions by the shadow director must be aimed at the actions of the directors in their capacity as directors.
4. A secured lender who gives instructions to a company in its role as debtor will not be deemed to be a shadow director, especially if the instructions given are backed by its contractual rights.

³⁵⁹ Corporations Act 2001

³⁶⁰ *Buzzle Operations Pty Ltd (In Liq) v Apple Computers Australia Pty Ltd* [2011] NSWCA 109

³⁶¹ *Id.*; *Shafon v ASIC* (2012) 88 ACSR 126

Courts have found banks to be shadow directors in certain situations. ***Banks were found to be shadow directors when engaging in soft receiverships or intensive care assignments***, as was the case in *3M Australia Pty Ltd v Kemish*.³⁶² The underlying test in this case is whether a person or entity has the ability to be involved in the company and to what degree that is possible.

b) *Liability for Environmental Harms*

Lender liability for environmental harms in Australia can take multiple forms, like clean-up and remediation costs for environmental harms caused by borrowers.³⁶³ Apart from shadow directorship, there may be other scenarios where lenders may be deemed liable for environmental harm caused by a borrower. Based on legislation and common law developments, liability may extend to lenders where lenders are³⁶⁴:

1. Involved with managing the borrower
2. Involved in decisions that cause an incident with adverse environmental effects
3. Aiding, abetting, counselling or procuring the offence
4. Occupying land where environmental harm occurs
5. In control of, or an owner of the land, plant, equipment, or substances that are involved in an incident causing environmental harm

Legislation in New South Wales and Victoria has been enacted regarding lender liability. In New South Wales, the two most important Acts that relate to lender liability are the Protection of the Environment Operations Act 1997 (“POEO”) and the Environmentally Hazardous Chemicals Act 1985 (“EHCA”).

The POEO classifies environmental offences into tiers, where Tier 1 offences constitute the most serious offences. Section 115 of the Act covers the willful or negligent disposal of waste that causes or is likely to cause environmental harm, and Section 116 covers willfully or negligently causing or contributing to leaks, spills or escapes that cause environmental harms, while section 117 covers the willful or negligent emission of ozone depleting substances. If found guilty of an offence under the POEO, a 'person' is liable to penalty in addition to an order requiring that the person abate and or mitigate harm caused by the offence.

Section 169 of the POEO states that the abovementioned Tier 1 offences attract special executive liability, which imposes liabilities on directors and managers of the corporation. To avoid Section 169 liability, the director must prove that they were not in a position to influence the conduct of the corporation or that they used all due diligence measures possible to prevent the contravention by the corporation. Section 169A of the POEO deals with Tier 2 offences, and imposes executive liability where the director or manager knew or ought to have known that the offence was committed, and failed to take “reasonable steps” to prevent the offence.

³⁶² (1986) 10 A.C.L.R. 371.

³⁶³ Xu, Yinshuo, Qian Liu, and Julie Cotter. "The impacts of environmental risks on bank loan covenants and the cost of bank loans: An Australian case study and the implications for China." Proceedings of the 2018 International Conference on E-Business and Applications. 2018.

³⁶⁴ Environmental Law 2019 Second Edition, Australia, Chambers and Partners

Under the EHCA, the New South Wales Environment Protection Authority may serve a notice to the occupier of the land to remediate the land.³⁶⁵

Scope exists under both the abovementioned acts for liability to be imposed on lenders. Under the POEO, lender liability is likely to result if the lender had control over the borrower when the environmental harms occurred. This may occur when a creditor is in the process of foreclosing on the borrower's property, or if the lender participates in the daily operations of the borrower, which may occur when the lender is trying to avoid insolvency.³⁶⁶

In *Environment Protection Authority v BMG Environmental Group Pty Ltd*,³⁶⁷ BMG negligently disposed of more than a million litres of untreated septic tank waste and untreated grease trap waste. The company and the director pleaded guilty under s 115(1) of the POEO. The New South Wales Land and Environment Court fined the director of the company and the company itself separately, as the director's liability arose from s 169. Thus, if a similar case arose where a bank was found to be a shadow director of a company that disposed waste negligently, the bank would be liable for the penalties imposed under s 169 of the POEO.

Under the ECHA, lenders may be liable for clean-up costs when it is the owner or occupier of the polluted property and thus subject to a remediation order. This may occur if the lender has obtained the title to land or exercised its right to take possession or appoint a receiver.³⁶⁸

In Queensland, the Environmental Protection (Chain of Responsibility) Amendment Act ("EPCRAA")³⁶⁹ was enacted in 2016 to amend the previous Environmental Protection Act³⁷⁰ and extends the class of persons and entities over which the Department of Environment and Heritage Protection has power to recover for environmental management and clean-up costs when the borrower is facing financial issues. ***Lenders may incur liability for environmental harms caused by a project where a lender has taken possession of a site, or where the security over the borrower allows the lender to appoint receivers to project assets.***³⁷¹ The EPCRAA also states that an Environmental Protection Order ("EPO") can be issued to a "related person" of a company as well as the company in question. Moreover, an EPO can be issued to a "related person" of a "high risk" company.³⁷² A related person is defined as, *inter alia*, a person or company with a relevant connection to the company causing harm through their ability to: (1) significantly financially benefit from the activity; or (2) influence the company's environmental conduct.³⁷³ ***Thus, lenders***

³⁶⁵ §35 of the Environmentally Hazardous Chemicals Act 1985

³⁶⁶ Mfodwo, K. (1991) 'Remediation and compensation after hazardous waste incidents: recent developments affecting companies and financial institutions in Victoria', *Environmental and Planning Law Journal* 8(3), 211-25
³⁶⁷ [2012] NSWLEC 69

³⁶⁸ Whelan, S., 1995. "Lender Liability: Apportioning the Cost of Environmental Remediation," 1995 Conference (39th), February 14-16, 1995, Perth, Australia 171151, Australian Agricultural and Resource Economics Society.

³⁶⁹ The Environmental Protection (Chain of Responsibility) Amendment Act 2016 (Qld)

³⁷⁰ Environmental Protection Act 1994 (Qld)

³⁷¹ Guideline, Environmental Protection Act 1994, Issuing 'chain of responsibility' environmental protection orders under chapter 7, part 5, division 2 of the Environmental Protection Act 1994

³⁷² Clare Corke and Julie Myers, Australia: Environmental liability for lenders in Queensland: the law in flux, 14 October 2016

³⁷³ Queensland Government, Environment: Department of Environment and Science, Policy and Legislation Changes

who are found to be shadow directors will be deemed to be “related persons” (as they are able to influence their borrowers) and may be held liable under the EPCRAA.

In the Second Reading Speech for the EPCRAA, the Minister for Environment and Heritage Protection stated that ***liability will not attach to genuine arm’s length investors (which includes merchant bankers).***³⁷⁴ ***However, the DEHP has discretion, and the mere fact that a lender provides finance under an arm’s length transaction will not automatically exclude liability.***³⁷⁵ ***Thus, a lender could be classified as a related person when the DEHP is satisfied that the lender had sufficient control or influence over the borrower, relating to how it complies with environmental standards, or if the lender benefits significantly from the borrower carrying out the relevant act (this applies regardless of whether the transaction is arm’s length or not). Moreover, EPOs can have retroactive application, and thus a lender can fall under the classification of a related person even if ceases providing financing.***³⁷⁶

2. Brazil

a) Lender Liability for Environmental Harms

The National Environmental Policy Act 1981 (“NEPA”) was enacted and has been the foundation of Brazil’s environmental legal framework.³⁷⁷ In 1998, the Environmental Crimes Act (“ECA”) was enacted to complete Brazil’s prosecutorial enforcement framework.³⁷⁸

Article 12 of NEPA states that public financial institutions and public subsidies entities shall make credit conditional upon verification of compliance with environmental standards. Article 3 defines polluters as anyone who directly or indirectly contributes to pollution. While the legislation does not directly refer to lender liability, prosecutors made the case that financial institutions can and should be held strictly and jointly liable for environmental harms caused.³⁷⁹

In 2009, the Superior Court of Justice (“SJT”), Brazil’s highest federal court of appeals on non-constitutional issues, implied that lenders may be considered as indirect polluters under NEPA under a strict, joint and several liability regime even prior to foreclosure.³⁸⁰ The court stated that: “For the purpose of determination of the proximate cause in environmental damage cases, one who commits [the act] shall be equated with one who does nothing when he or she should act, who allows it to happen, who does not care what is being done, who is financing so that it can be done, and who benefits when others act.”³⁸¹

<https://environment.des.qld.gov.au/management/policyregulation/changes#review_of_queenslands_environmental_chain>

³⁷⁴ Environmental Protection (Chain of Responsibility) Amendment Bill 2016 Explanatory Notes

³⁷⁵ *Id.*

³⁷⁶ *Supra* n 23

³⁷⁷ Environmental Policy Act No. 6.938.

³⁷⁸ Environmental Crimes Act (Federal Law 9.605/1998)

³⁷⁹ Reis, A. A. (2011). Financing and Environmental Liability: A Comparative Analysis of Financial Agent’s Liability Against the North American Model and Brazilian Superior Court of Justice (SJT) Precedents at 469.

³⁸⁰ S.T.J.-T2, REsp 650728, Relator: Min.Benjamin Herman, 23.10.2007, Revista Do Superior Tribunal De Justica [R.S.T.J.], 02.12.2009 (Braz.)

³⁸¹ *Id.*

The case involved environmental damages in a mangrove area, and did not directly concern liability of a financial institution. Thus, the above statement is *obiter dicta*, but is the first to define who is considered to be indirectly responsible, and has expanded liability to include both direct polluters and anyone involved with a direct polluter. The Court also made it clear that indirect polluters (which may include lenders) can be independently liable for the full amount of damages.³⁸²

In another case involving the Federal Public Ministry and the Brazilian Development Bank (“BNDES”), where the Federal Public Ministry sued BNDES for environmental damages due to a borrower’s mining activities, the Superior Court of Justice (SJT) implied that banks can limit liability by establishing diligent inquiry, but confirmed lender liability where funds were given even with knowledge of environmental risks.³⁸³ The Court stated:

Regarding BNDES, the simple fact that it is the financial institution responsible for financing the mining activitiesat a first analysis, does not establish that it can be a defendant in the case. However, if there is evidence that this government-owned corporation [BNDES] was even aware of serious and severe environmental harm [and] ...has released intermediate or final disbursements to the mining project ..in this case, [BNDES] shall be under a joint and several liability for damages.

On the issue of due diligence, a Circuit Court stated that a financial institution can be held liable for (1) failure to conduct a due diligence analysis before granting credit; or (2) identifying a borrower’s practice not in compliance with the environmental legal regime whenever a funding contract exists.³⁸⁴

The basis and scope of the abovementioned liability is found in Article 14 of NEPA, which states that polluters are required to compensate or repair damage caused to the environment or to third parties regardless of fault. It is important to note here that suing a polluter under Brazilian tort law does not require proof of recklessness or malpractice; only causation and injury need to be established. Liability for environmental harm is strict.³⁸⁵

As a polluter is defined as any person who is *directly or indirectly responsible* for environmental harms, the environmental legislation imposes a joint and several liability regime, which allows for liability to be apportioned among multiple parties.³⁸⁶

Brazilian law goes even further on lender liability, and courts have concluded that plaintiffs who are harmed by environmental damages can decide which polluter (direct or indirect) to pursue for damages, alongside the defendants’ rights to sue other parties who contributed to the harms.³⁸⁷ However, the defendant’s right to sue other parties cannot be joined with the plaintiff’s

³⁸² Bianca Zambão, Brazil’s Launch of Lender Environmental Liability as a Tool to Manage Environmental Impacts, 18 U. Miami Int’l & Comp. L. Rev. 47 (2014)

³⁸³ S.T.J., REsp 995321, Realtor: Min.Benedito Gonçaves, 15.10.2007, R.S.T.J., 15.12.2009 (Braz.)

³⁸⁴ UNEP, Inquiry Working Paper, 16/07, Lenders and Investors Environmental Liability: How much is Too Much?

³⁸⁵ S.T.J., REsp 1056540, Realtor: Min. Eliana Calmon, 16.05.2008, R.S.T.J., 14.09.2009 (Braz.)

³⁸⁶ Supra n 32

³⁸⁷ *Id.*

claim against it, and can only be brought in a different action, as the fault of the other parties responsible for harm is not related to the primary claim of environmental harm, which is based on strict liability.³⁸⁸ ***This is important, as lender usually have “deep pockets”, and are the “best” choice for plaintiffs who suffered harms as a result of pollution.***³⁸⁹ ***Thus, it is likely that lenders will be the most attractive defendant for plaintiffs to go after for damages.***

Thus, under Brazilian law, lenders can be considered indirect polluters since the only elements required to establish a case of indirect pollution are injury and causation. If causation is construed as being established where harm would not have occurred without the party’s conduct (or where the party’s conduct contributes to injuries), lenders may be likely to satisfy this requirement as the projects would not have occurred without funds being disbursed from the lenders, thereby fulfilling the requirement of causation.

Apart from the aforementioned areas of lender liability, a lender can also be called to remediate contamination of foreclosed property. Even if causation cannot be established between the credit and the property or the activities causing harm, the responsibility to repair arises from the legal link between the owner of the property and the property itself based on the *propter rem* theory. Thus, *propter rem* obligations attach to the title of the property and are transferred to future owners.³⁹⁰ ***Thus, banks may face liability for remediation costs for contamination if the property is foreclosed. In one case, the Superior Court of Justice found the State Ministry of Sao Paulo (the defendants in the case) liable for environmental harm simply because it acquired a property that was contaminated by previous owners.***³⁹¹

The Brazilian Constitution states that both “[t]he government and the community have the duty to defend and preserve [the ecologically balanced environment] for present and future generations.”³⁹² This is a potential emerging ground for environmental lender liability, given that lenders are part of the community, and that they have a duty to protect the environment. The Constitution also goes further by enshrining the right to compensation for environmental harm, as Article 225 states that “... Conduct and activities considered harmful to the environment shall subject the violators, be they individuals or legal entities, to criminal and administrative penalties, without prejudice to the obligation to repair the harm.”

Therefore, Brazil has constitutionalized environmental goals. Even though the Constitution includes a provision for compensation under the chapter of social rights, a private right to recover damages is also available.³⁹³ This would allow third parties concerned with environmental harms

³⁸⁸ T.J.R.S, Ap. Civ. No. 70032034183, Relator: Des. Carlos Roberto Lofego Canibal, 16.12.2009, Didrio da Justiga do Rio Grande do Sul [D.J.R.S.], 8.2.2010 (Braz.) (quoting HUGO NIGRO MAZZILI, A DEFESA DOS INTERESSES DIFUSOS EM Juizo, 260 (18th ed. 2005))

³⁸⁹ Nhapi, Everjoy Chenai. The accountability of lending institutions for environmental damage under the lender liability principle. Diss. North-West University (South Africa), Potchefstroom Campus, 2015.

³⁹⁰ Supra n 32

³⁹¹ S.T.J., REsp 948921, Relator: Min. Herman Benjamin, 23.10.2007, R.S.T.J., 11.11.2009 (Braz.).

³⁹² Art 225 of the Brazilian Constitution

³⁹³ See Lei No. 5.869, de 11 de Janeiro de 1973, D.O.U. de 27.07.2006 (Braz.).

to pursue claims on behalf of the environment in its own right, even where they do not act on behalf of individual victims.³⁹⁴

3. Canada

b) Limited Lender Liability for Contaminated Land Clean-Up

In Canada, it is uncommon for lenders to incur liability for environmental harm caused by their borrowers.³⁹⁵ Federal environmental statutes, the most prominent of which is the Canadian Environmental Protection Act, impose no liability on persons other than the one who directly caused significant harm to the environment.³⁹⁶ ***Provincial environmental laws, on the other hand, only impose liability for contamination clean up upon lenders when the lenders take possession of the land as the owner of the land or are directly responsible for the contamination.***³⁹⁷

Under British Columbia's Environmental Management Act, for example, a secured creditor is responsible for the costs of contamination clean-up if (a) it "exercised control over or imposed requirements on any person regarding the manner of treatment, disposal or handling of a substance and the control or requirements, in whole or in part, caused the site to become a contaminated site", or (b) it "becomes the registered owner... of the real property at the contaminated site".³⁹⁸ ***A secured creditor is not liable for the remediation of the contaminated site if "it acts primarily to protect its security interest".***³⁹⁹ Most notably, the Act provides that the following actions only constitute acting to "protect [a secured creditor's] security interest" and thus do not trigger lender liability:⁴⁰⁰

- participates only in a purely financial matters related to this site
- has the capacity or ability to influence any operation at the contaminated site in a manner that would have the effect of causing or increasing contamination, but does not exercise that capacity or ability in such a manner as to cause or increase contamination
- imposes requirements on any person, if the requirements do not have a reasonable probability of causing or increasing contamination at the site
- appoints a person to inspect or investigate a contaminated site to determine future steps or actions that the secured creditor might take

Ontario's Environmental Protection Act has a similar exemption for secured creditors. In particular, the Act shielded lenders from liability if, without more, lenders conducted the following actions:⁴⁰¹

- Any action taken for the purpose of conducting, completing or confirming an investigation relating to the secured property
- Any action taken on the secured property for the purpose of responding to

³⁹⁴ Supra n 64

³⁹⁵ <https://ca.practicallaw.thomsonreuters.com/2-503-2764>

³⁹⁶ Canadian Environmental Protection Act § 22(2)

³⁹⁷ <https://ca.practicallaw.thomsonreuters.com/2-503-2764>

³⁹⁸ British Columbia, Environmental Management Act § 43(3)

³⁹⁹ *Id.*, § 43(4)

⁴⁰⁰ *Id.*

⁴⁰¹ Ontario, Environmental Protection Act § 168.17

- any danger to the health or safety of any person that results from the presence or discharge of a contaminant on, in or under the property
- any impairment or serious risk of impairment of the quality of the natural environment for any use that can be made of it that results from the presence or discharge of a contaminant on, in or under the property, or
- any injury or damage or serious risk of injury or damage to any property or to any plant or animal life that results from the presence or discharge of a contaminant on, in or under the property.

Lenders are further protected from liabilities in situations where lenders take over a contaminated site from defaulting borrowers by the Bankruptcy and Insolvency Act. The Act was amended to provide that, notwithstanding any other federal or provincial law, a trustee in bankruptcy is not liable for any environmental damage that occurred before the trustee's appointment, or after such appointment, unless the damage is a result of the trustee's gross negligence or willful misconduct. Within this section, a trustee includes a receiver or other party appointed to take possession or control of an insolvent person's property.

Similar to CERCLA in the U.S. (discussed in *Section II(A)(2)*), lender liability for environmental harm is likewise circumscribed. ***While lenders do not have an obligation to conduct environmental due diligence, conducting such precautionary due diligence investigation does not seem to be enough to strip a lender of its shield under the relevant statutes.*** For example, British Columbia's Environmental Management Act specifically allows a secured creditor to "[appoint] a person to investigate a contaminated site to determine future steps or actions".⁴⁰² Ontario's Environmental Protection Act recognizes a similar exemption to liability so that lenders are allowed to take any action "for the purpose of conducting, completing or confirming an investigation relating to the secured property" without the risk of incurring liability for the contaminated site.⁴⁰³ As a result, ***lenders enjoy broad protection with regard to environmental harms caused by their lenders and may implement due diligence schemes without exposing themselves to lender liability.***

c) Lender Liability in Negligence Claim – Standard for Duty of Care

In negligence claims brought against lenders, the Supreme Court of Canada had developed the *Anns/Cooper* test, a two-stage analysis to determine whether the defendant bank owed a duty of care to a third-party plaintiff who is harmed by the borrower to whom the bank provided services: First, whether the harm which occurred was reasonably foreseeable from the defendant bank's act, and second, regardless of the proximity of the parties, whether residual policy concerns outside the parties' relationship may negate the imposition of a duty of care.⁴⁰⁴

Following this standard, the courts have recognized a duty of care owed by banks to non-customers in cases where the bank's customers engaged in fraudulent activity in the following circumstances:

⁴⁰² British Columbia, Environmental Management Act § 43(3).

⁴⁰³ Ontario, Environmental Protection Act § 168.17

⁴⁰⁴ *Anns v. Merton London Borough Council*, [1978] A.C. 728; *Cooper v. Hobart*, [2001] 3 S.C.R. 537

- for non-customers who were asked by their customers to deal with them, the bank owes a duty to not knowingly permit their banking services to be used to perpetuate fraud;⁴⁰⁵
- after the bank obtains actual knowledge of its customers' fraudulent activity or proposed fraudulent activity, the bank owes a duty of care to third parties to take steps to prevent the use of the bank's services to perpetuate fraud.⁴⁰⁶

In other words, courts recognized that a bank owes a duty of care to a non-customer when the bank has actual knowledge of its customer's fraudulent activities. To discharge this duty, courts have held that the bank can terminate its services to the customer and report the customer to the appropriate authorities.⁴⁰⁷

However, if a bank does not have actual knowledge of the existence of fraud, courts are unwilling to recognize any duty of care owed to third parties, given that no relationship of proximity exists when the defendant bank has no prior relationship with the non-customer plaintiff: "Absent actual knowledge of the business activities of a customer, including the details of its fraudulent activities, it is impossible to define the class of persons who may be affected and in whose favour the duty of care can be said to arise."⁴⁰⁸

Additionally, the bank does not seem to have a duty to detect fraudulent activities of its customer, the knowledge of which may trigger banks' duty to third parties. In particular, a bank does not have a general duty of care to know of all banking activities of its customer or all suspicious activities of its customer.⁴⁰⁹ Nor does it have a general duty of care to monitor all banking transactions to detect suspicious transactions.⁴¹⁰

While the discussion above is limited to the context of fraud, it nevertheless implies a broad protection of banks against liability arising from a borrower's fraudulent misconduct. Any duty a bank may owe to a non-customer only seems to arise when the bank has actual knowledge of the borrower's fraud and the bank does not have a duty to implement policies to detect borrower's misconduct. As a result, while financial institutions are not obligated to implement policies such as due diligence to detect fraud, they are unlikely to be exposed to a risk of liability if they choose to do so, except in situations where due diligence reveals borrowers' actual fraudulent misconduct and the bank does not take positive steps to protect victims of the borrowers from loss.⁴¹¹

4. New Zealand

A lender may be found liable for harms caused by a borrower's activities if it can be shown that the lender had control over the borrower.

⁴⁰⁵ *Semec Industries Ltd. V. 1131426 Ontario Ltd.*, [2001] O.J. No. 3443 (S.C.J.), para. 65.

⁴⁰⁶ *Dynasty Furniture Manufacturing Ltd. v. Toronto-Dominion Bank*, 2010 ONSC 436 (Dynasty SCJ), cases cited in paragraphs 51 and 56; affirmed 2010 ONCA 514 (Dynasty OCA).

⁴⁰⁷ *Dynasty OCA*, paras 5 and 9.

⁴⁰⁸ *Dynasty SCJ.*, para. 70.

⁴⁰⁹ *Id.*, para. 60.

⁴¹⁰ *Id.*

⁴¹¹ Geoff Hall "Something Borrowed: A Sensible Definition of a Bank's Duty of Care in Tort to Non-Customers" *Banking & Finance Law Review*; Toronto Vol. 27, Iss.3, (Mar 2012) 505-511.

In New Zealand, a creditor may incur liability for harms caused by a borrower if the creditor can be called a “shadow director”. Shadow directorship is mentioned in section 126 of the Companies Act 1993 (New Zealand). The section states that a person or entity can be a director if, *inter alia*, they occupy the position of director by whatever name they are called, i.e. shadow directors⁴¹² Thus, under New Zealand legislation, the extended definition of director now applies to *anyone who assumes the roles and responsibilities of a director, even without the company or board’s acquiescence*. Reading the wording of the section closely, a finding of shadow directorship can be made if even one director acts in accordance with the directions or instructions of the “shadow director”, unlike similar provisions in the UK, where the whole board must be accustomed to act according to the instructions given by the “shadow director”.⁴¹³ ***Thus, creditors (i.e. banks) who assert influence through advice and instructions for the management of a business and are thus closely involved in a borrower’s business and operations may possibly be held liable for harms caused by borrowers.***⁴¹⁴ This is especially important when a bank chooses to exert control over the board of the borrowers instead of appointing an administrative receiver, and therefore engages in “soft receivership” or “intensive care assignments”.⁴¹⁵

In New Zealand, entities or persons acting solely in a “professional capacity” will not be considered shadow directors.⁴¹⁶ A professional capacity generally refers to actions that are done in accordance with the performance of the professional relationship between the parties, in exchange for consideration.⁴¹⁷ Actions done in a professional capacity are also usually impartial.⁴¹⁸ Examples of those who act in a professional capacity include financial advisors and lawyers. ***However, where control is exercised over borrowers, it is unlikely that a lender is acting purely in a professional capacity, for example where the lender requires the borrower to follow the bank’s recommended strategies.***⁴¹⁹

Based on the above, most creditor liability in New Zealand flows from whether the lender has acted in the capacity of a “shadow director”. When lenders are deemed to be shadow directors, they may face liability under statutory provisions that impose penalties on directors for harms caused. In the context of environmental harms, the Australian and New Zealand Environment and Conservation Council (“ANZECC”) has made a few recommendations. While these recommendations are not part of legislation, they may be persuasive to courts when analyzing the basis of liability. The ANZECC has recommended that “where the polluter is insolvent or unidentifiable, the person in control of the site, irrespective of whether that person is the owner or the current occupier, should be liable, as a general rule, for the costs of any necessary remediation”.⁴²⁰ Thus, this is applicable to lenders where lenders have: (1) obtained title to the

⁴¹² Companies Act 1955; Companies Act 1993.

⁴¹³ Kuwait Asia Bank v NML Nominees [1990] 3 WLR 397.

⁴¹⁴ Coetzee, Johannes Hendrik. Sustainability–environmental risks and legal liabilities of South African banks. Diss. 2013; *Re a Company No. 005009 of 1987 ex parte Copp.*, [1989] B.C.L.C. 13; 4 B.C.C. 424.

⁴¹⁵ 25 Victoria U. Wellington L. Rev. 283 (1995) Banks as Shadow Directors

⁴¹⁶ §126(4) of the Companies Act 1993

⁴¹⁷ Turing, “Lender Liability, Shadow Directors and the Case of Re Hydrodan (Corby) Ltd” (1994) 9(6) Journal of International Banking Law 244, 245.

⁴¹⁸ J. Breslin, Banking Law, 2nd edn (Dublin: Thomson Round Hall, 2007), p.557.

⁴¹⁹ State National Bank of El Paso v Farah Manufacturing Co Inc 678 SW 2d 661 (Tex App 1984)

⁴²⁰ ANZECC, Financial Liability for Contaminated Site Remediation: A Position Paper (1994) 5 at 9.

land; or (2) exercised a right to take possession; or (3) appointed a receiver or manager in bankruptcy.⁴²¹

Under the Resource Management Act 1991 (“RMA”), banks may incur liabilities for adverse effects or harms to the environment. Section 17 states that every “person has a duty to avoid, remedy, or mitigate any adverse effect on the environment arising from an activity carried on by or on behalf of that person...”.⁴²² Moreover, section 314 enables the Environment Court to make enforcement orders against any persons or entities, and require them to mitigate any effects on the environment caused by or on behalf of the person.⁴²³ ***These provisions may be used against banks or their officers who become consultants or shadow directors, and may thus be liable for the clean-up of a contaminated site.***⁴²⁴

According to section 340(3) of RMA, a director may be liable for offences under the act if: (1) the relevant act or omission took place with their authority or consent; and (2) they failed to take all reasonable steps to prevent it.⁴²⁵ As the definition of directors under New Zealand law includes shadow directors, lenders who are deemed to be shadow directors according to the criteria above may also be liable under the RMA if the relevant factors are fulfilled. Once the court finds that an entity or a person has acted as a shadow director, it will impose the same standards of liability it employs for the defendant principal.⁴²⁶

⁴²¹ Australian and New Zealand Environment and Conservation Council (1993) Financial Liability for Contaminated Site Remediation, Australian Government Publishing Service, Canberra

⁴²² Resource Management Act 1991

⁴²³ Id.

⁴²⁴ 25 Victoria U. Wellington L. Rev. 283 (1995) Banks as Shadow Directors

⁴²⁵ § 340(3), Resource Management Act 1991

⁴²⁶ See Re Tasbian [1993] B.C.L.C. 297 (C.A.)

II. Conclusion

The NYU International Organizations Clinic was tasked with researching commercial lender liability for environmental and social harm in a variety of jurisdictions, and with considering the relationship of due diligence to lender liability in those jurisdictions. One of the purposes of this research was to consider the possible implications for Multilateral Development Banks if they were to conduct more expansive human rights and environmental due diligence activities.

As this Report has outlined, existing legal frameworks and relevant case law governing lender liability for environmental and social harms in the U.S., the UK/EU, and Hong Kong, as well as under a selection of relevant legal frameworks in Australia, New Zealand and Canada (with Brazil standing as something of an exception), is broadly circumscribed. In sum, while lender liability may be contemplated in specific, limited instances, robust lender liability shields exist for commercial banks for environmental and social harms caused by the projects in which they invest. While there appears to be a general trend of imposing lender liability on banks which take on a direct oversight or management role of a given project's day to day operations, this is generally a high bar to meet, and one that can be protected against via a number of legal exemptions in each jurisdiction.

Given the limited scope of lender liability for commercial banks in the array of jurisdictions researched here, it seems unlikely that lender liability for environmental and social harms could be imposed on multilateral development banks. It is of course worth noting however, that unlike domestic commercial banks, MDBs are public, mission-driven institutions, and as such they face different incentive structures and reputational risks regarding the prevention of harm to communities affected by the projects which they finance.

However, while it may prove difficult to subject multilateral development banks to legal liability for the harms resulting from their lending activities, the relatively lax lender liability frameworks in the jurisdictions analyzed in this report may suggest that there are few incentives for the MDBs to undertake stronger and better due diligence activity. On the other hand, the findings of this report suggest that Multilateral Development Banks which choose to implement strong and voluntary due diligence policies do not thereby increase the risk of subjecting themselves to lender liability. The many shields and protections against lender liability in the jurisdictions researched above suggest that MDBs may implement strong human rights due diligence policies without raising lender liability risk.